SEPTEMBER 1960

VOL. XXX NO. 9

THE NEW YORK Certified Public Accountant

blished monthly by
New York State Society
of
ied Public Accountants
ngle Copy 50 Cents
One Year $5.00

LE

ts

AY

erman

me
ns.

m.

);

Foreign

s
e Insur-

THE NEW YORK
Certified Public Accountant

September 1960 Volume XXX No. 9

CONTENTS

Accounting News And Trends

CLIENT REFERRAL SERVICE

In a letter to members, the President of The Colorado Society of CPAs outlines a novel approach to the problem of how the Society can help bring individual CPAs and prospective clients together. The letter points out that much of the public relations work of the Society is directed toward getting business men to seek the help of CPAs when confronted with any one of a variety of business problems. As a result of this publicity, some business men have called the Society requesting to be put in touch with a CPA. The letter proposed that such a business man be put in touch with a "Society Referral Service" where he will be referred to a particular CPA. It is proposed that this Referral Service operate under the following rules:

For the CPA

1. He must be a member of The Colorado Society and be engaged in full-time public practice.
2. He must agree to charge no more than $.............................. for the first consultation up to one-half hour.
3. He must personally interview all clients referred or return such cases to the CPA Referral Service promptly for re-referral.
4. He must accept all referrals graciously and handle work promptly and in a professional manner, bearing in mind that this is a public service of the Colorado Society of CPAs.

For the Clients

1. He must state his name and address and general nature of his problem.
2. He must verify that no CPA-client relationship presently exists.
3. He must agree to pay $.......... for the first consultation up to one-half hour and understand that fees for further services are to be arranged by client and CPA on a usual basis.

For the Referral Service

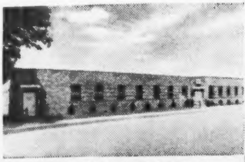
1. Once a year a registration card shall be mailed to each CPA in the Society and those interested shall complete the card and return it.
2. The Society office will talk to the client who calls and then select the first card in the file and refer the case to that CPA. The CPA will be notified and his card will then be placed in back of the file.
3. If the client referred does not keep his appointment, the CPA shall notify the Society office and his card shall then be placed at the front of the file again.
4. This manner of strict rotation shall be followed in all cases unless the client, without solicitation, insists on a CPA of a particular age, sex, or geographic location.

BANK CONFIRMATION PROBLEMS

An article by W. Gale High, entitled "Bank Confirmations—Do's & Don'ts" (*The Illinois CPA*, Spring 1960), points out certain problems and shortcomings of the standard confirmation form. This article is a digest of the recommendations contained in a booklet bearing the same title that

---

Accounting News and Trends is conducted by CHARLES L. SAVAGE, CPA. He is presently serving as a member of our Society's Committee on Membership and is active in the National Association of Accountants. Dr. Savage is professor of accounting and chairman of the Business Administration Division of St. Francis College. He is also professor of taxation at the New York Law School.



MODERN EXTERIOR of Pic Design Corporation.

WILLIAM J. FRASER, JR., CONTROLLER of Pic Design Corp.

PRECISION INSTRUMENTS like these are made by Pic Design Corp.

THIS NATIONAL SYSTEM paid for itself in less than fifteen months.

was recently distributed to the Illinois Society members. The general comments not related to the form itself include a number of practical suggestions.

Advance planning. Advance planning of the audit engagement should include the confirmation program. Banks would prefer, in most cases, to have the request on hand before the "as of" date. This allows more effective scheduling and planning of the bank work load. Also, current information is much easier to confirm.

Timely review. Bank confirmations should be reviewed promptly upon their receipt by the accounting firms. This permits corrections or clarifications to be made on a current basis while the information is readily available.

Telephone requests. Telephone requests for confirmation, if made at all, are to be followed up with a written request. Fortunately, such requests are not a large percentage of the total. The bank must be assured that the release of information is authorized and that the proper person receives such information.

Cut-off bank statement. Requests for "cut-off" bank statements in a separate letter are desirable. In most banks, these are handled by a different section than the confirmation request; a separate letter saves time and helps prevent the omission of a request.

In their attempts to be of service to CPAs through furnishing bank confirmations, bankers have noted a number of problems arising from the present bank confirmation forms.

Account titles. Banks receive many forms in which the exact name of the customer and the account title are not shown. Depositors frequently have several accounts with a bank. Inaccurate listing of account titles may lead to a reply that, according to bank records, no such account exists. Some

accountants have expressed the opinion that disclosure of account titles defeats, in part, the purpose of their request. They prefer to ask for "all accounts" thus seeking disclosure of unrecorded client assets. However, the bank normally will interpret the authorization as limited to the capacity of the signer. If John Doe signs the confirmation request as Treasurer of the XYZ Company, then only accounts in that company name will be confirmed. Normally, no search is made of the bank records to determine beneficial interests, if any, in other accounts. The location of unrecorded assets could be accomplished by other feasible auditing techniques.

Confirmation as of two dates. Two forms are necessary for bank processing if all information is required for two different dates. Where "balance only" information is desired for one date, the form should clearly so indicate. Forms are often received showing two "as of" dates with no indication of the actual audit date. Unless the accountant indicates that "balances only" are required for one date, records throughout the bank must be rechecked in order to complete the entire standard form as of the additional date.

Duplicate deposit slips. Banks are requested to authenticate deposit slips, furnish duplicate deposit slips, furnish dates of credits prior to and subsequent to the audit date, and occasionally to permit the public accountant to compare the depositor's duplicate deposit slip (authenticated by the bank) with the original deposit slip from the bank's records. Apparently, from the number of requests received, many accountants believe that each deposit is proven by the bank in detail. Actually, this is not so. General procedure results in a proof of currency and of total checks. Therefore, the only confirmation a bank can make of a de-

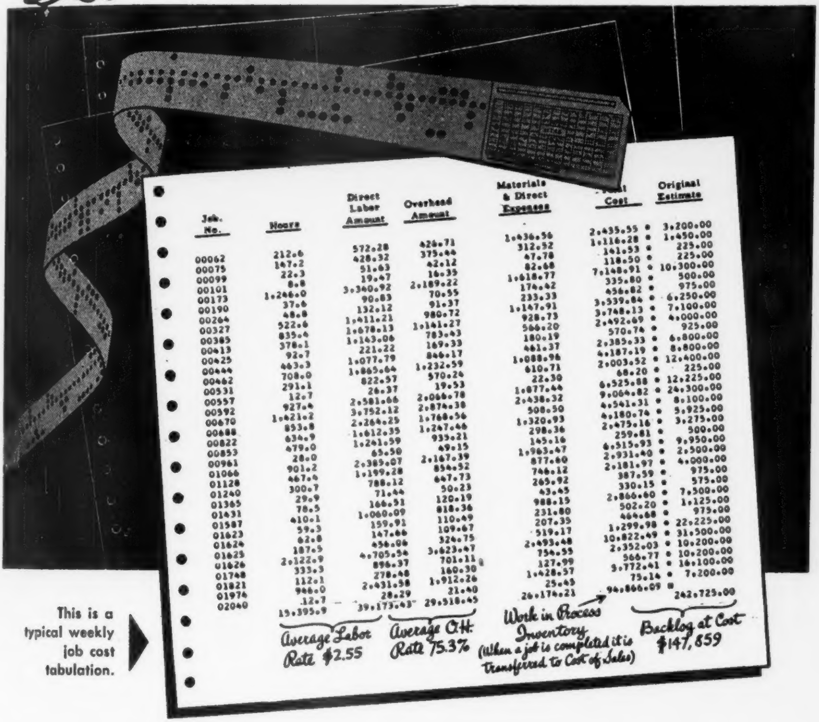
posit, usually, is that of totals. The fact that the details on the original and the duplicate deposit slips agree is no assurance that the items listed were the actual items received by the bank. Many accounts in banks are what are known as "concentration accounts." In such accounts it is difficult to locate a deposit without knowing the date of the credit. Inasmuch as receipted copies and supporting data are sent to the depositor, properly authenticated by the bank, prompt and accurate certification will be expedited if such copies are returned with the request for additional information.

Confirmation of securities. Confirmation of securities held, usually referred to as "safekeeping," presents recurring difficulties. Although many bank customers do have items in safekeeping with the bank, the proportion is not such as to warrant inclusion of this request as part of the standard form. Unless there is specific indication of safekeeping, this request should be omitted. Here again, the timely receipt of the request is important, since it is time consuming and difficult to reconstruct the bank records for an audit date some time in the past.

STUDENTS AS
PROFESSIONAL ASSOCIATES

Indicative of the growing interest in drawing accounting students closer to the profession (see also the "Student Associate" item in this department, June 1960), is the fact that the 1,500 members of Beta Alpha Psi, the honorary accounting fraternity, are now receiving *The CPA*, the membership bulletin of the AICPA. In the April 1960 issue of this bulletin, John L. Carey welcomes them as readers and points out that this is one of the ways in which these potential CPAs can be informed as early as possible of what the present CPAs are doing and thinking—and what their problems are.

A LITAB COST ACCOUNTING SYSTEM



Job. No.	Hours	Direct Labor Amount	Overhead Amount	Materials & Direct Expenses	[illegible] Cost	Original Estimate
00062	212.6	572.28	426.71	1.436.56	2.435.55 •	3.200.00
00075	147.2	428.32	375.44	312.52	1.116.28 •	1.450.00
00099	22.3	51.63	42.12	47.78	161.53 •	225.00
00101	8.8	19.47	16.35	82.68	118.50 •	225.00
00173	1.246.0	3.340.92	2.189.22	1.618.77	7.148.91 •	10.300.00
00190	37.6	90.83	70.55	174.42	335.80 •	500.00
00264	48.8	132.12	91.37	233.33	456.82 •	975.00
00327	522.6	1.411.21	980.72	1.147.91	3.539.84 •	6.250.00
00385	835.4	1.678.13	1.141.27	928.73	3.748.13 •	7.100.00
00413	378.1	1.143.06	783.43	566.20	2.492.69 •	4.000.00
00425	92.7	221.22	169.33	180.19	570.74 •	925.00
00444	463.3	1.077.79	846.17	461.37	2.385.33 •	6.800.00
00462	708.0	1.865.64	1.232.59	1.088.96	4.187.19 •	8.800.00
00531	291.1	822.57	570.24	610.71	2.003.52 •	12.400.00
00557	12.7	26.37	19.53	22.30	68.20 •	225.00
00592	927.4	2.581.66	2.066.78	1.877.44	6.525.88 •	12.225.00
00670	1.621.2	3.752.12	2.874.38	2.438.32	9.064.82 •	24.300.00
00688	853.8	2.264.25	1.768.56	508.50	4.541.31 •	8.100.00
00822	634.9	1.612.35	1.247.46	1.320.93	4.180.74 •	5.925.00
00853	479.0	1.241.59	935.21	298.36	2.475.16 •	3.275.00
00961	28.0	65.50	49.15	145.16	259.81 •	500.00
01066	901.2	2.385.07	2.167.39	1.963.47	6.515.93 •	9.950.00
01128	467.4	1.199.28	854.52	877.60	2.931.40 •	2.500.00
01240	300.7	788.12	647.73	746.12	2.181.97 •	4.000.00
01365	29.9	71.44	50.23	265.92	387.59 •	975.00
01431	78.5	166.51	120.19	43.45	330.15 •	575.00
01587	410.1	1.060.09	818.36	988.15	2.866.60 •	7.500.00
01623	59.3	159.91	110.49	231.80	502.20 •	1.125.00
01624	62.8	147.66	109.67	207.35	464.68 •	975.00
01625	187.5	456.06	324.75	519.17	1.299.98 •	22.225.00
01626	2.122.9	4.705.54	3.623.47	2.493.48	10.822.49 •	31.500.00
01748	333.3	896.37	701.11	754.55	2.352.03 •	10.200.00
01821	112.1	278.48	160.30	127.99	566.77 •	10.200.00
01976	946.0	2.431.58	1.912.26	1.428.57	5.772.41 •	16.100.00
02040	12.7	28.29	21.40	25.45	75.14 •	7.200.00
	15.395.9	39.173.43	29.518.45	26.174.21	94.866.09	242.725.00

This is a typical weekly job cost tabulation.

NOW you can have all the details you need for full cost accounting studies at your fingertips . . . with record breaking speed . . . and at a price you can afford.

Through the exclusive LITAB System, we are supplying detailed accumulated Job Costs of MATERIAL, LABOR, OVERHEAD and BACKLOG information, tabulated on a single, easily read form, to many of our customers.

Sound management decisions are a must in modern business . . . management decisions can be no better than the information upon which they rely.

To find out how you can take advantage of high speed cost accounting, call either office.

LITCO Long Island Tabulating Corporation
384 Clinton Street, Hempstead, New York
IVanhoe 1-9460

NYTAB New York Tabulating Corporation
386 Park Avenue South, New York 16, N.Y.
MUrray Hill 5-7277

SUBSIDIARIES OF

Nationwide Tabulating Corporation
384 Clinton Street, Hempstead, New York

Letters to the Editor

MUNICIPAL FINANCE AND A REQUEST FOR CREDIT

On behalf of the Division of Business Administration and Commerce of Pan American College, may I express our appreciation for the complimentary comments which you carried in the "Accounting News and Trends" department of *The New York Certified Public Accountant,* in your May 1960 issue concerning W. E. Tinsley's paper which was presented at our Second Annual Accounting and Management Conference, and later carried in *The Texas CPA* magazine, January 1960 issue. The paper was entitled "Are Your Financial Reports Costing You Money."

You will note from the enclosed copy of the proceedings of the conference (held in April 1959) and from the enclosed reprint that the editor of *The Texas CPA* magazine inadvertently omitted to credit the original source from which the reprint came. We allowed the Texas Society to use our plates for reprinting 5,000 copies of the Tinsley paper for distribution to officials of Texas cities, counties and other political subdivisions. The fact that the conference, where the paper was read, was sponsored by the City Officials Association, the local chapter of the Texas Society of CPAs, and the College, was unique. More than one hundred city officials, representing eighteen South Texas towns and cities, and about fifty CPAs were present when the paper was presented.

As a result of this conference the City of Edinburg has improved its accounting and audit work and has received a Certificate of Conformance from the Municipal Finance Officers Association. Hidalgo County has received a similar certificate, to become the first county in Texas to receive such a certificate. The County Auditor, Robert McLeaish, Jr., is a member of the local CPA chapter which sponsored the conference. The mayor of Edinburg, Honorable Joe Davis, has stated that the conference made it possible for the city to win the coveted certificate, which he feels will enable the city to save money on future bond issues.

It will be appreciated if you will mention the source of Mr. Tinsley's paper in an early issue of your magazine.

ROBERT S. SEE
Director, Division of Business Administration and Commerce, Pan American College
Edinburg, Texas

A UNIFORM PLAN ON CONTINUITY OF PRACTICE

The members of our State Society may be interested to know the present status of our efforts to provide professional guidance to those who are temporarily incapacitated and to the estates of deceased members.

Recently, the Executive Committee of our Board of Directors approved a uniform plan to guide the various chapter committees on continuity of practice or on emergency assistance. We now will turn our attention to the preparation of working rules and regulations under the uniform plan; to the preparation of a plan for the non-chapter down-state area; and to the preparation of a series of educational articles. These articles will be designed to acquaint our members with the various problems which may be encountered in the event of an illness or a death so that they may be encouraged

to do as much advance planning as possible.

Meanwhile, our Committee on Continuity of Practice continues to furnish to the estates of deceased practitioners such advisory guidance as has been requested. It is our hope that the influence of our Committee will continue to grow so that emergency assistance may be provided on an advanced professional basis. This, we believe, is both in the public interest and in the interest of widows and other dependents of deceased practitioners.

We hope to have more to report before the close of this calendar year.

ALBERT KRAUTER, CPA
Chairman, Committee on Continuity of Practice
New York, N. Y.

QUESTIONS AND ANSWERS ON AUDITING PROCEDURE

You may wish to publish a summary of certain of the matters discussed at

the technical session of April 27, 1960 sponsored by our Society's Committee on Auditing Procedure. The following questions asked from the floor or suggested by the moderator were answered by a panel of committee members.

Question. I have several clients for whom I prepare interim financial statements without detailed audit or independent verification — and usually based on an estimated inventory figure or on the basis of an inventory "required to break even." I have not been typing these reports on my regular stationery, but on plain paper without signature, covers, or qualifications. Do you approve of this practice?

Answer. The panel expressed the preference that the accountant use his report paper or letterhead and clearly disclaim an opinion, conforming to the requirements of the proposed Rule 19 of our Society's Rules of Professional Conduct, and to the American Institute's Statement on Auditing Procedure No. 23. In support thereof, it was maintained that once an accountant releases the financial statements to a client, he has no control over their use and if the client, using the statements for credit purposes, represents that they were prepared by his accountant, the accountant can hardly disclaim this fact at a later date.

Question (asked by a New York banker). We occasionally see statements certified by firms where one or more of the partners are a part of the active management of the company. We believe that the independent accountant should be truly independent and objective, and not closely affiliated with the subject of the audit.

Answer. Proposed Rule 13 of our Society's Rules of Professional Conduct states: "A member shall not express his opinion on financial statements of an enterprise if he, a partner in his firm, or a member of his im-

mediate family owns or is committed to acquire a financial interest in the enterprise, or if he or a partner in his firm is an employee or director of the enterprise, unless he discloses such interest, employment or directorship in his report."

Question (asked by a New York banker). One of our pet peeves is the certification that specifies "it is subject to the comments contained in the attached report" and then the comments run on for pages and the reader has to evaluate whether the detailed description of the audit procedures justifies or supports the certification; also, statements which purport to be certified with qualifying comments which really destroy the apparent certification, such as certifications qualified by the statement that the inventory was submitted by the management when the inventory is the principal asset, or certifications qualified by the comment that the accountant did not verify the receivables or payables.

Answer. The reply to this question related to the American Institute's Statement on Auditing Procedure No. 23, with emphasis on the fact that if exceptions or qualifications are sufficiently material to negate the opinion, no opinion should be expressed but rather should be specifically disclaimed.

Question. Should the auditor complete the form of and sign the certifi-

cate of the bank or credit agency, or is it more desirable to submit a report which gives the required information, but in the CPA's manner of reporting?

Answer. The accountant must put all qualifications contained in his report, on any forms of a bank or credit grantor which he is asked to sign. If his comments or qualifications are too numerous, it may be advisable to write, above the accountant's signature on the form, the words "Subject to the comments and qualifications contained in our report dated..........., attached herewith." Wherever possible, a copy of the accountant's report, as originally submitted, should be stapled to the agency or bank form and referred to thereon, since many problems of arrangement of items and space for notes or explanations arise when trying to conform to a printed form of the bank or credit agency.

Question. A client has the major portion of its inventory in the hands of dealers on consignment, and at various warehouses; is this a "practical or reasonable" exception to the requirement that we must observe the inventory count to render an opinion on the financial statements?

Answer. The CPA or his representatives should be present at inventory counts at the larger locations and should confirm by direct correspondence a good cross-section of the dealer and warehouse inventories, in order to render an unqualified opinion. (See page 22 of AICPA's *Codification of Statements on Auditing Procedure.)*

The foregoing is not intended as a verbatim account nor does it cover all of the matters discussed at the meeting.

STEPHEN CHAN, CPA
(Eisner & Lubin)
Chairman, Committee on
Auditing Procedure
New York, N. Y.

THE PRESIDENT'S PAGE

The Role of the CPA in Government Affairs

Our profession can be justly proud of the active role in government affairs played by its members in recent years. Currently, Maurice H. Stans is serving as Director of the Budget, and our own Society members William B. Franke, as Secretary of the Navy, and Joseph Campbell, as Comptroller General. In recent years our members Percy Brundage and Percy Rappaport served as Director and Assistant Director of the Budget, respectively. Other outstanding examples have been T. Coleman Andrews and Russell B. Harrington as successive Commissioners of Internal Revenue, and Abraham D. Beame, Director of the Budget for New York City.

Of equal significance has been the voluntary service devoted by numerous leaders of the profession in the work of the Hoover Commission and currently in the development of accounting policies of such agencies of the Federal Government as the SEC, the Small Business Administration, and the Internal Revenue Service.

Similar activities are being demonstrated at the State and local level in New York State. For some years our Society has had an Advisory Committee to the State Comptroller which has been rendering a public service in fiscal areas. Our committees have also been of assistance to the State Tax Commission in both the legislative area and the development of tax forms; similarly with respect to the New York City Department of Finance. We also participated actively in the studies for the revision of the State's Constitution.

Among other governmental departments that have benefited from our Society activities have been the State Welfare Department in connection with the develop-

ment of forms for reports of charitable organizations, the State Labor Department in the design of reports by employers and labor unions, the State Banking and Insurance Departments in legislative areas, and the State Education Department in its over-all regulation of the accounting profession.

These activities are only a beginning. We can and should go much further. We are undertaking assistance to such agencies as the State Rent Control Commission and New York City child care agencies. We should have the same opportunity to offer our services in governmental endeavors to improve State and municipal tax laws as we have with regard to provisions of the Internal Revenue Code. We can do so not only through advance review, evaluation and criticism of proposed legislation, but also by participation in the development of a legislative history through public hearings, and later in the formulation of the regulations of the Tax Departments. Such steps are indicated as a matter of public service in view of the vast tax amounts involved, and they should also serve to minimize both controversy at the administrative level and litigation.

New York State and its numerous municipal, county, town and village governments, and its many school districts, are concerned with billions of dollars in fiscal management. As CPAs we should take the initiative to direct the need for our services whenever they can be helpful to the public. We should be prepared to participate in significant financial, budget and tax posts where our training and experience are required. Such voluntary efforts in the long run should be of substantial benefit to the public and to our clients in improving the character and administration of our State and local governments. They should result in a greater dependence and reliance by the public and its governmental officials on the services of the CPA.

BENJAMIN GRUND,
President

When Your Client "Goes Public": An Accountant's Introduction to the Securities Act

By Louis H. Rappaport, CPA

For the certified public accountant who is called upon to undertake his first SEC engagement, this article provides a basic introduction to the accountant's function and responsibilities in certifying the financial statements, and to the requirements relating to his client's financial representations, under the Federal Securities Act of 1933. The reader is furnished with a step-by-step guide which embraces: references to pronouncements and publications with which he should be familiar; the registration process; registration forms; auditing and accounting features; relationships with lawyers; and other significant phases of an SEC engagement.

Your client has been giving a great deal of thought to making a public offering of the company's securities. He has carefully weighed the advantages as well as the disadvantages, and has finally decided to make the plunge.* And, because you, as his independent public accountant, have an important role in his objective, he has told you of his decision.

You, on the other hand, have a small, general practice and have never had occasion to be concerned with the laws and procedures relating to the sale of securities to the public. Now, however, you've got to find out what it's all about so that you can do the job that's expected of you. One alternative is to tell your client that this is a specialized field about which you know very little, and that he might be better off in the long run if he employed a public accountant with experience in this field. Another alternative is to employ someone experienced in this field to consult with, and advise you, throughout the registration process.

You reason, however, that the laws and regulations are written in English,

LOUIS H. RAPPAPORT, CPA, is chairman of the Committee on Cooperation with Investment Bankers and Security Dealers of the New York State Society of Certified Public Accountants. Mr. Rappaport, who is the editor of "Accounting and the SEC," a monthly department in The New York Certified Public Accountant, is a partner in the firm of Lybrand, Ross Bros. & Montgomery, certified public accountants.

* For a discussion of the advantages and disadvantages involved in going public, see *The New York Certified Public Accountant,* May 1960, p. 351.

that they probably are no more complicated than the tax laws and regulations, and so you decide not to bow out of the engagement and not to seek help from others. Now you have to learn what's involved and what needs to be done insofar as it relates to the accountant's function. The purpose of this article is to give you a brief run-down on what you need to know.*

TOOLS TO DO THE JOB

What do you or any other accountant need to know if the client is to be served effectively? First of all, the accountant needs to be familiar with the securities laws—most of all the Federal Securities Act of 1933 and, to a lesser extent, the state securities laws. If the accountant is expected to do a creditable job in examining and certifying the financial statements, he must know what the statutes demand of him and what are the requirements relating to the issuer's financial representations.

The accountant must be familiar with the SEC, its rules and regulations, and know how the SEC works. The accountant must have first-hand knowledge of Regulation S-X — the Commission's basic accounting regulation which sets forth the requirements as to form and content of financial statements, the requirements as to certification and the qualifications of accountants. He must also be familiar with SEC pronouncements on accounting and auditing matters set forth in the Accounting Series Releases. He must have available to him a copy of the appropriate registration form being filed by his client (Form S-1, for example) and the applicable instructions.

All of the foregoing may be obtained from the Washington office of the Commission or they may be seen in the loose-leaf reference services on this subject.

THE FEDERAL LAW

The federal law governing the offering of securities to the public is the Securities Act of 1933, as amended. It was one of the earliest New Deal laws, and, together with several other statutes, is administered by the Securities and Exchange Commission (the SEC). Some of the other laws administered by the SEC include the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, and the Investment Company Act of 1940.

The 1933 law provides for the registration of securities with the Commission before they can be sold to the public. The Commission has the power to exempt from registration small offerings, that is, where the aggregate amount of the offering does not exceed $300,000. Offerings under this exemption are frequently referred to as "Reg. A offerings."

The 1933 act is a disclosure statute, the disclosure being provided by means of a registration statement and a prospectus each of which contains specified financial and other information. Offerings under Regulation A frequently—but not always—require an "offering circular," which is not as elaborate as a regular prospectus.

The 1934 act relates to securities exchanges and securities listed on exchanges, over-the-counter markets, and the activities of brokers and dealers. In this article we shall be concerned principally with the 1933 act. If, however, your client decides to list on an exchange after "going public," then you will also be concerned with the 1934 act.

*** ED NOTE: For a comprehensive treatment of this subject, see "SEC Accounting Practice and Procedure," by Louis H. Rappaport, CPA, Ronald Press Co., revised printing (1959). See especially Appendix A which is a bibliography of important literature in this field.**

STATE SECURITIES LAWS

Most of the states also have laws governing the sale of securities in those states. These laws are called "blue sky" laws and vary considerably among the various states.

Many states exempt from the operation of their securities laws securities which are listed on designated stock exchanges and securities which are senior to those so listed. Some states provide that if the securities in question are registered with the SEC, they are exempt from registration with the state commission. In other states the filing with the state commission of a copy of the registration statement and prospectus filed with the SEC fulfills the state registration requirements.

As a rule, there is very little that the accountant is expected to do in order to help qualify the securities in various states once they have been registered with the SEC. It is desirable for the accountant, however, to discuss this point with counsel for the company or counsel for the underwriter. Occasionally, one of the states in which the securities are to be sold may have an obscure accounting requirement which may demand the accountant's assistance.

THE SEC

The main office of the SEC is in Washington. It also has regional offices in several principal cities, including New York City.

The Commission consists of five members appointed by the President of the United States. One member is designated by the President to serve as chairman.

The Commission is assisted by a staff of professional employees (consisting of accountants, lawyers, engineers, security analysts, and examiners) and by administrative and clerical employees. The staff is organized into a number of divisions and "offices." The public accountant whose client is going public will be principally concerned with the Division of Corporation Finance.

The SEC's job is to examine the registration statement and prospectus to see that full and accurate disclosure is made of all pertinent information, so that the prospective investor may have a basis for deciding whether or not to purchase the securities. The SEC does not pass on the merits of securities. The Commission is only concerned to see that all the material facts with respect to a security are truthfully told and no material information is withheld. The investor must make up his own mind whether to buy the security.

THE REGISTRATION PROCESS

The preparation of a registration statement for filing under the Securities Act is almost invariably a combined operation. It is a combined operation in the sense that representatives of the management of the registering company, the underwriters, the independent public accountants, counsel for the company, counsel for the underwriters, and sometimes engineers or appraisers —all of them have an important role in preparing the registration document. When the registration statement is completed, an executed copy will be filed with the SEC.

The registration statement will be reviewed in the Division of Corporation Finance. The reviewing group will include a lawyer, an accountant and a financial analyst, and sometimes other experts, such as mining engineers or petroleum engineers. The group, working individually and collectively, will review the registration statement and will confer among themselves as to their findings. After this review, a "letter of comment" will be sent to the

registrant setting forth those respects in which it appears that the registration statement fails to comply with the SEC's rules, regulations and instructions and the requirements as to completeness demanded by the law. As far as the letter relates to accounting matters, it will have been reviewed by the Chief Accountant of the Division. For some time, such letters have also been known as "deficiency letters."

When the registration document has not been carefully prepared, the letter of comment may prove to be extremely troublesome. On a visit to Washington recently, the author was told of a deficiency letter running to 18 pages, all of the comments being matters of substance and relating solely to the financial section. This certainly does not reflect credit on those who had a hand in its preparation. In the case of a carefully prepared document, however, the SEC's comments are few and minor in character. Whether the comments are few or many, however, they cannot be ignored; they must be taken care of. If the SEC's comments are well founded and material, the registration statement must be appropriately amended.

CORRECTING DEFICIENCIES

That portion of the SEC's comments relating to the financial statements is usually delegated to the issuer's financial and accounting personnel and the certifying accountants. Between them they usually agree on what, if anything, to do about the SEC's comments which are of immediate concern to them.

If it is decided to comply with the Commission's comments, the question remains: How to do it so as to be sure of obtaining the staff's agreement. Usually this can be disposed of by a telephone call to inform the staff of the Commission how the matter in question is to be dealt with in the amendment which will be filed.

If, however, it is decided to resist the SEC's suggestions or comments, or if the suggestions or comments are not clear, a more difficult problem arises. Time is important, and the issuer and underwriter are often not in favor of opposing the SEC's suggestions where the matters involved are, in their view, not vital. All too often issuers comply with those SEC suggestions which they believe are without merit for the sole purpose of having the registration become effective so that the securities may be sold.

The great majority of the SEC's comments and suggestions are very worthwhile indeed. It would be surprising if they were otherwise, because they represent the views of a battery of experts—lawyers, accountants, analysts, engineers, and others. Sometimes, being human, they are wrong, or their suggestions are impractical. Sometimes their comments may be based on a misunderstanding of the facts because of inadequate information. When that happens, they should be told why they are wrong or in what respect their suggestions are impractical or based on insufficient information.

If the matter in question relates to the financial data rather than the textual matter, it is advisable to have the accounting people (the comptroller of the company or the certifying accountant, for example) take the question up with the Chief Accountant of the Corporation Finance Division. It is emphatically not advisable for lawyers to discuss accounting matters with the SEC, just as accountants should not take up legal matters with the SEC.

EFFECT OF FILING AN AMENDMENT

All amendments to the registration

statement are examined by the staff of the SEC in the same manner as the original registration. If it appears that the registration as amended still needs work, a further letter of comment will be issued.

Whenever an amendment to a registration statement is filed, it has the effect of starting the waiting period all over again unless the Commission consents to the registrant's request to consider that the amendment is filed "now as of then." This is referred to as granting "acceleration" to an amendment, the granting of which is discretionary with the SEC. The power to deny acceleration is a potent means by which the SEC can impose its will in a situation where it might not otherwise be able to do so.

THE PRICE AMENDMENT

When a registration statement is filed, usually there is a meeting of minds between the issuer and the underwriter as to the type of security to be sold. In almost all cases, however, the issuer and underwriter have not agreed on the price at which the securities are to be offered to the public, the underwriter's discount or commission, and the proceeds to the issuer. Similarly, if the registration statement relates to senior securities, there is usually no agreement as to the precise terms, or the interest or dividend rate.

While the registration statement and the amendment curing the SEC's deficiencies are in process of preparation, negotiations are conducted leading up to the final underwriting agreement. At the appropriate time the underwriting agreement will be signed by the issuer and the underwriters. At this time another amendment to the registration statement will be prepared. This amendment will fill in the blank spaces in previous SEC filings relating to the interest rate, the dividend rate, the public offering price, the underwriter's discount or commission, and the net proceeds to the company (or selling stockholders). This is called the "price amendment," and at the time of its filing the issuer (or selling stockholder) and the underwriter customarily request acceleration so that the offering may be made promptly. The result of this procedure is that the waiting period in the registration process, in effect, becomes the negotiating period.

SEC DECLARES REGISTRATION EFFECTIVE

When the staff of the SEC inform the Commissioners that they have no important reservations with respect to the registration statement, the Commission declares the registration statement effective. Then—and only then—are the issuer and the underwriter in a position to proceed with the proposed sale. Before declaring the registration effective, one of the matters the Commission will consider is the timeliness of the financial statements. The statements may have been filed within the required period, but because of the delays in processing, the statements may be stale. Especially when business in general or the industry in particular are in a descending cycle, the Commission may call for more recent statements. There is no hard-and-fast rule, however, on this matter.

REGISTRATION FORMS

The SEC has promulgated several registration forms applicable to different types of issuers. An issuer may have a choice of forms depending on the type of securities being registered. Form S-1 is used for registration of securities of all issuers for which no other form is authorized or prescribed. Since it is the form most often used, these remarks will be confined to it.

FORM S-1

Form S-1 consists of two parts. Part I contains those items of information which must be included in the prospectus. Part II contains those items which need not be included in the prospectus.

Part I consists of 21 items of information. They deal with such matters as a description of the business and its development in the last five years, a description and location of the principal plants, mines, and physical property, the capital structure, information about the securities being registered, names of directors and officers, remuneration of directors and officers, legal proceedings, and the like. Accountants are primarily interested in Items 6 and 21. Item 6 contains the requirements for the summary of earnings; Item 21 the requirements for financial statements.

Item 21 contains the detailed instructions specifying the financial statements which must be furnished for the registrant, for the registrant and its subsidiaries consolidated, for unconsolidated subsidiaries, for so-called 50 percent owned companies, and for certain special situations, such as reorganizations, successions, and acquisitions. Item 21 specifies the date as of which the balance sheets are to be furnished, and the period to be covered by the income statements. The item also specifies the extent to which the statements shall be certified. Item 6 specifies what is required in respect of the summary of earnings, the period to be covered, and the information to be furnished.

While Item 21 states *what* statements are to be furnished, and the *period* they are to cover or the *date* as of which they are to be furnished, the instructions do not specify the *form* or *content* of such statements. For the requirements as to form and content of the financial statements, recourse must be had to Regulation S-X, the Commission's basic accounting regulation under practically all of the statutes administered by it.

FLEXIBILITY OF REQUIREMENTS

In the instructions for financial statements in Form S-1, there is also a section providing for the filing of other statements in certain cases. It provides as follows:

> The Commission may upon the request of the registrant and where consistent with the protection of investors, permit the omission of one or more of the statements herein required, or the filing in substitution therefor of appropriate statements of comparable character. The Commission may also require the filing of other statements in addition to, or in substitution for, the statements herein required in any case where such statements are necessary or appropriate for an adequate presentation of the financial condition of any person whose financial statements are required, or whose statements are otherwise necessary for the protection of investors.

As an indication of the flexibility permitted by the section quoted above, the author recalls a case involving a registration by a company which had a significant subsidiary. The product manufactured by the subsidiary was sold principally to the parent company for further processing; the production of the parent company was sold to the public.

The construction of the subsidiary's plant had been financed principally by bonds sold privately to insurance companies. The indenture securing the bonds provided for a pricing formula of the subsidiary's products that was calculated to provide the subsidiary with funds to pay the interest and principal on its funded debt. The statements of the parent company alone or of the subsidiary alone were meaningless because they reflected operations under an arbitrary pricing arrangement. The only financial state-

ments that had any significance were the consolidated statements of the group.

The registration statement in this case was to be filed by the parent company and the proceeds were to be used principally to redeem the subsidiary's debt. After the registration became effective, the only debt to be outstanding would be that of the parent company. The pricing formula under the old indenture would be eliminated when the related bonds were redeemed. The instructions in Form S-1, however, called for parent company (unconsolidated) statements to be filed as well as consolidated statements. It seemed that no good purpose would be served by filing unconsolidated statements of the parent company. The question of omitting such statements was discussed with the staff of the SEC. The staff agreed that parent company financial statements should be omitted from the proposed filing.

The point to bear in mind is this: If you have a case where the SEC's requirements call for a statement or a presentation that doesn't make sense to you, talk to the SEC people. If you are right, the chances are they will agree with you.

INQUIRIES AS TO REQUIREMENTS; THE PRE-FILING CONFERENCE

The staff of the SEC is available for consultation both before and after a registration statement is filed with the SEC. The Commission urges all persons having questions concerning its requirements to discuss their problems freely with the staff. This can be done any way you like: by letter, by telephone or in person at the Commission's main office in Washington.

Whenever there are important problems that need to be resolved in advance of filing, the author strongly recommends the pre-filing conference. This conference not only enables the issuer and his accountant to obtain the SEC's view at an early date with regard to a problem, but it also affords the staff an opportunity to ask questions and thereby elicit more background information than is usually available from bare financial statements. Experienced practitioners frequently make use of this procedure; they find it not only saves expense in the long run but—what may be more important—it also saves time. Especially where the time schedule for a security flotation is tight, the factor of time can be an important consideration.

REGULATION S-X

Regulation S-X is the principal accounting regulation under practically every act administered by the Commission. *No public accountant should attempt an examination of financial statements intended for filing under the Securities Act, unless he has at hand an up-to-date copy of the regulation.*

The regulation specifies the items of information and degree of detail to be set forth in the financial statements and supporting schedules. It provides, for example, that income statements must show sales and cost of sales. This requirement alone has caused many prospective registrants to change their minds about filing with the SEC, because they are unwilling to disclose their percentages of gross profits.

The regulation also contains the requirements for the accountant's certificate, the rules regarding consolidated statements, and the required notes to financial statements.

An accountant undertaking an examination of financial statements for filing under the 1933 Act should have knowledge of the requirements of the law, the rules and regulations there-

under. The accountant should also be familiar with the Commission's pronouncements on accounting matters.

To issuers and underwriters desiring to have a registration become effective at the earliest possible date, it is important that the registration as originally filed be free from errors of omission or noncompliance. This alone is sufficient reason why public accountants should be thoroughly familiar with Regulation S-X and with the applicable form and instruction book. Because it is a basic tool with which he must work constantly, the accountant must be thoroughly familiar with Regulation S-X. In most respects the requirements of this regulation are not much different from those of good practice generally; the regulation, however, contains certain provisions—particularly in the area of footnote disclosure — which are not presently required by good accounting practice.

ACCOUNTING PRINCIPLES NOT PRESCRIBED BY SEC

Although the SEC has authority under the law to prescribe the accounting principles to be followed in financial statements filed with it, the Commission has not, with very few exceptions, invoked its authority to dictate how financial statements shall be prepared. In Regulation S-X, it has set forth its requirements as to the form and content of financial statements filed with it. In its decisions and in the Accounting Series Releases, it has stated its opinion concerning a limited number of accounting principles and practices. As to the large body of accounting principles underlying the preparation of financial statements, however, the SEC has for the most part been content to rely on generally accepted principles of accounting as they exist or develop with the passage of time.

Under generally accepted accounting principles, in some circumstances certain profits and losses are included in earned surplus. In a filing with the SEC, however, these gains and losses must be included on the income statement as special items after the item designated as net income. This represents a compromise in a dispute between the SEC and the accountancy profession. The SEC preferred the all-inclusive income statement in which all items of income and expense recognized during the period would have been included in the income statement. The American Institute of CPAs felt that the current operating performance type of income statement was a more useful statement. Thus, a substantial profit on sale of a plant may be included in earned surplus in a report to shareholders, but in an SEC filing the profit must be shown on the income statement as a special item *after* net income.

TAX ACCOUNTING IS NOT NECESSARILY GOOD ACCOUNTING

It seems almost needless to point out that tax accounting is not the same as generally accepted principles of accounting. And yet one of the chief difficulties encountered by the SEC results from the inclusion in registration statements of financial statements prepared on a tax basis, but certified by public accountants as being in conformity with generally accepted accounting principles. This may seem ridiculous, but it represents a serious problem to the Commission staff. Financial statements have been filed, for example, in which life insurance premiums were charged to surplus for the sole reason that they were not deductible for tax purposes. Other statements have been filed with

the SEC in which the current provision for federal income taxes was also charged to surplus—presumably on the basis that, in effect, it represented a sharing of profits with the Government.

AUDIT PROCEDURES NOT PRESCRIBED BY SEC

As far as the 1933 Act is concerned, the SEC does not prescribe the audit procedures to be followed by the independent public accountant. The Commission has broad powers under the law to prescribe the detailed steps to be followed by accountants, but, for the most part, has been content to let the profession make its own rules. In its report on the McKesson & Robbins case the Commission considered the desirability of adopting specific rules and regulations governing the auditing procedures to be performed by accountants in certifying financial statements for filing with the SEC. In view of the steps then taken by the profession with respect to confirmation of receivables and observation of inventories, the SEC concluded that, for the time being, it would not prescribe the detailed scope and procedures to be followed in an audit for SEC purposes.

If the auditor's examination complies with the pronouncements of the American Institute of CPAs, he need have no fear that his audit falls short of SEC standards.

ACCOUNTING SERIES RELEASES

From time to time, the rules and regulations of the SEC are amended and new ones are issued. Notices to that effect are given in so-called "releases." The SEC from time to time also publishes in the form of releases, opinions of its Chief Accountant relating to major accounting questions, and certain other material of importance to accountants. Public accountants should familiarize themselves with these releases which are published as the Accounting Series.

In 1938 the Commission issued in Accounting Series Release No. 4, a statement of its administrative policy with respect to financial statements which should be read carefully. This release is of prime importance. In brief, it says that if the statements filed with the SEC are based on unsupportable accounting principles, disclosure will not correct them. If the statements reflect an accounting principle which has been formally disapproved by the SEC, the statements will be presumed to be misleading. It means that an accountant whose clients file financial statements with the SEC is charged with a knowledge of the SEC's accounting opinions.

THE CERTIFICATE

Not all of the financial statements in a registration statement need to be certified by independent public accountants. Most of the statements, however, must be so certified. In this respect the accountant must consult the applicable instructions for financial statements to see what statements must be furnished and which must be certified.

As to the requirements of the accountant's certificate, recourse must be had to Rule 2.02 of Regulation S-X. Because of its importance, the rule is reprinted below:

Rule 2.02. Accountants' Certificates.

(a) Technical requirements. The accountant's certificate shall be dated, shall be signed manually, and shall identify without detailed enumeration the financial statements covered by the certificate.

(b) Representations as to the audit. The accountant's certificate (i) shall state whether the audit was made in accordance with generally accepted auditing standards; and (ii) shall designate any auditing pro-

cedures generally recognized as normal, or deemed necessary by the accountant under the circumstances of the particular case, which have been omitted, and the reasons for their omission.

Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required by paragraph (c) of this rule.

(c) Opinions to be expressed. The accountant's certificate shall state clearly: (i) the opinion of the accountant in respect of the financial statements covered by the certificate and the accounting principles and practices reflected therein; (ii) the opinion of the accountant as to any material changes in accounting principles or practices or method of applying the accounting principles or practices, or adjustments of the accounts, required to be set forth by rule 3.07; and (iii) the nature of, and the opinion of the accountant as to, any material differences between the accounting principles and practices reflected in the financial statements and those reflected in the accounts after the entry of adjustments for the period under review.

(d) Exceptions. Any matters to which the accountant takes exception shall be clearly identified, the exception thereto specifically and clearly stated, and, to the extent practicable, the effect of each such exception on the related financial statements given.

The AICPA has recommended to its members the use of a standard "short" form of report. The recommended form of report appears in *Codification of Statements on Auditing Procedure* issued by the Institute. Ordinarily, this form of report will comply with SEC requirements as stated in Regulation S-X, but those requirements must not be lost sight of when drafting the certificate. For example, where there is a significant difference between the accounting principles and practices reflected in the accounts and those in the financial statements, the accountant must so state in his certificate and give his opinion as to the differences.

CERTIFICATION BASED ON INADEQUATE EXAMINATIONS

In a privately-owned company, the management may also be the owners of the business and, having no responsibility to other owners, they are sometimes willing to settle for less than a conventional unqualified accountant's report if it means a reduction in the audit fee. Management may limit the scope of the accountant's examination by asking the accountants not to observe the taking of physical inventories, or not to confirm receivables.

In the long run, this policy is penny-wise, pound-foolish. Management can never be absolutely certain of what need they may have for fully certified financial statements. It is impossible to predict what event or transaction may arise in connection with which they should be able to furnish conventional certified statements. How much better it is to furnish a clean certificate when called upon to do so, rather than explain why a qualified certificate is all that is available. Certainly, a certificate based on a conventional examination costs more than one based on a limited examination, but the client gets more, too.

If management decides to register with the SEC, the certifying accountant may have a real problem in satisfying himself as to intervening inventories if his prior examinations have been limited in scope. The SEC law and regulations call for *certified* financial statements. If the accountant's report contains an important qualification running to inventories, for example, the SEC may well take the position that the statements are not certified.

"KEEPING CURRENT" REVIEW

Section 11 of the Act sets forth the conditions under which the accountant

can be sued for a misstatement or omission. Although any technical interpretation of this section would call for analysis by a lawyer, it seems to the author that it says, in effect, that *when it becomes effective,* the registration statement must be true and there must be no material omissions.

As far as the accountant is concerned, this means that his job is not finished when the registration statement is filed. It means that after the filing and up to the effective date, he must take steps to ascertain whether anything has happened in the interim that materially affects the certified statements. The AICPA Committee on Auditing Procedure recognized this problem, and, in Statement on Auditing Procedure No. 25, made some suggestions for keeping currently informed. *All accountants who practice before the SEC should be familiar with this Institute pronouncement.*

CONFIDENTIAL TREATMENT

A question frequently asked is whether any of the information required by the SEC may be filed in confidence and not disclosed to the public. In general, a registration statement is a public record, and anything in it is available for public inspection when it is filed. There are rules providing for the non-disclosure of certain contracts, for the omission of information with respect to foreign subsidiaries, and classified information. With these exceptions, there is no provision for confidential treatment of information—including financial information. There is nothing to prevent a registrant from applying for confidential treatment of a portion of the financial statements. In the author's opinion, the application has little possibility of being granted.

INDEPENDENCE OF ACCOUNTANTS

So much has been said about accountants' independence, that it would hardly seem necessary to dwell on the subject. And yet, experience demonstrates that this is a subject that must be constantly in mind—and particularly so when doing SEC work.

The SEC did not invent the concept of independence, but they certainly sharpened it. This is a matter that you must consider very carefully at the beginning of an SEC engagement. If it should be discovered after a registration is filed that there are reasonable grounds to doubt the accountant's independence, and if the SEC should later decide that the accountant was not independent, the accountant might be accused of torpedoing the whole financing. Not only would the client be put to the expense of employing new auditors, but what may be more important, the financing would have to be delayed until the new auditors had completed their examination.

The author knows of a case where the registrant's accountant owned 40 percent of a company that owned the plant in which the registrant operated. In a sense, then, the accountant was the registrant's landlord. It was suggested to the accountant that he talk to the SEC about whether this relationship disqualified him. He did as suggested, and the SEC ruled that he was not independent. The company was put to the expense of employing new auditors with consequent delay in the time schedule.

In Rule 2.01 of Regulation S-X the Commission sets forth its formal requirements as to accountants' independence. The rule is as follows:

> **(b) The Commission will not recognize any . . . accountant as independent who is not in fact independent. For example, an accountant will be considered not independent with respect to any person or any of its parents or subsidiaries in whom he has, or had during the period of report, any direct financial interest or any material in-**

direct financial interest; or with whom he is, or was during such period, connected as a promoter, underwriter, voting trustee, director, officer or employee.

(c) In determining whether an accountant may in fact be not independent with respect to a particular person, the Commission will give appropriate consideration to all relevant circumstances, including evidence bearing on all relationships between the accountant and that person or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission.

The accountant is forbidden to be an officer of his client not only at the date of making his report but also during the period covered by his report. The same is true with respect to serving as a director, or employee, or in any other of the capacities named. The same is true with respect to having a financial interest in his client. In other words, if the accountant had a financial interest in his client, he cannot cleanse himself for SEC purposes by disposing of that interest. The SEC takes the position that during the period when his independence was a factor, the accountant was not independent, and so he is disqualified with respect to certifying for that period.

In addition to Rule 2.01 the SEC has made numerous informal rulings relating to accountants' independence. A few of these rulings follow; they give only an indication of the SEC's thinking on this question. There have been literally hundreds of such rulings.*

A & B, a firm of CPAs, examined and reported upon the financial statements of XYZ Corporation for the years 1955, 1956, and 1957. In 1958, B (one of the partners of the firm) acquired a substantial interest in his client, became a director of the company, and an officer of one of the subsidiaries. Because of his changed status, another firm was engaged to audit and report upon 1958. In 1959, XYZ filed a registration statement under the 1933 Act, and the question was raised whether A & B could certify the years 1955, 1956 and 1957. The SEC ruled that A & B could certify those years, and demanded only that their certificate be dated not later than their original certificate covering the latest of such years.

A partner in an accounting firm which certified financial statements of a company owned 11,000 shares of the company. In an apparent effort to avoid conflict, an amended financial statement was filed which was prepared by an employee of the accountant, and certified jointly by the employee and the firm. The employee received from the registrant company a cash payment for his services, but had no other interest in the registrant. The SEC held that the rule requiring accountants to be independent would be defeated and evaded if the accountant alone were disqualified but his partner or employee were not.

If a partner in an accounting firm serves on the board of directors of a company but does not participate in any way in his firm's audit of the company, would the firm be disqualified? The SEC has taken the position that the firm could not be considered independent.

In a slight variation of the foregoing situation, a partner in the accounting firm served as a member of a registrant's board of directors. Another partner in the same accounting firm conducted the audit of the registrant and certified the financial statements in his own name, *not in the firm name.* The SEC held that the certifying accountant could also not be considered independent.

* See, for example, the decisions in SEC Accounting Series Release No. 81 (1958). See also the detailed discussion of independence in "SEC Accounting Practice and Procedure," Chapter 16.

The SEC has stressed in several instances the importance of separating the functions of recordkeeping and independent auditing. In the Commission's view an accountant may not hold himself out as independent in respect of financial statements prepared from accounting records which he has kept. For example, an accounting firm that certified the financial statements of a company had followed the practice of drawing up the monthly journal records of the company from underlying documents that had been prepared by the company's staff. These journal records were posted to the appropriate ledgers by the certifying accountants. At the end of the year the audit engagement was undertaken by personnel of the certifying accountant who were not connected with the original recording of the accounting data. The Commission ruled that the accounting firm was not independent.

Keeping books even on a temporary basis may raise a question as to an accountant's independence. In one case, members of a firm of accountants set up a registrant's books and maintained them for about six months until the registrant engaged a bookkeeper. The SEC ruled that the accounting firm could not be considered independent with respect to the registrant for the year in which the accountants kept the books.

Not all SEC rulings on independence are adverse to the accountants. The author knows of a case where an accountant's partner followed the practice of personally making the postings to the general ledger. The partner did not, however, make any entries in the books of original entry. In view of all the SEC decisions involving recordkeeping by accountants, it seemed that a problem might exist, and so the accountants decided to discuss the situation with the SEC. The Commission ruled that in the circumstances of this particular case, the accounting firm was independent, with the understanding, however, that the posting practice would be discontinued.

Family relationships, outside business relationships, indemnity agreements—all of these may raise a question as to the accountant's ability to certify for SEC purposes. If you have these or any other relationships with a particular client which raise a question in your own mind concerning your independence by SEC standards, the only safe thing to do is check the rulings to see if a precedent exists for your case. If there is no such precedent, the next thing to do is to take it up with the staff of the Commission. They may give you an answer that you don't like, but you're much better off knowing it early rather than late.

THE CONSENT

The 1933 Act provides that "if any accountant . . . is named as having prepared or certified any part of the registration statement, . . . the written consent of such person shall be filed with the registration statement."

Below is a suggested form of consent which, with appropriate modifications, may be used by the certifying accountant:

> We consent to the inclusion of the following reports in the registration statement to be used in registering, under the Securities Act of 1933, (title of issue) of (name of company):
>
> (1) our report dated .... accompanying the financial statements of (name of company) and the summary of earnings, which are included in the prospectus;
>
> (2) our report dated .... accompanying the supporting schedules listed in Item 31 of the registration statement; and
>
> (3) our report dated .... accompanying the historical financial information listed in Item 31 of the registration statement.

We also consent to the references to our firm under the captions "Earnings" and "Experts" in the prospectus.

(Name of certifying accountants)

(City)

(Date of signing)

RELATIONSHIPS WITH LAWYERS IN SEC WORK

The preparation of a registration statement not only affords a splendid opportunity for close cooperation between accountants and lawyers; such cooperation is a "must." Although the public accountant is concerned primarily with the financial section of the registration document, he does not confine himself to the financials. Similarly, although the lawyer is concerned primarily with the narrative section, he does not limit himself to the narrative. Each expert is often in a position to advise and assist the other.

As far as the accountant is concerned, there are a number of reasons for reading the entire prospectus section of the registration statement. First of all, the accountant wants to be sure that the representations in the narrative section do not conflict with the representations in the financial section. Second, there are few outsiders as familiar with the affairs of the company as the independent accountant. Consequently, he is almost invariably able to make helpful and constructive suggestions with respect to the information in the narrative section. Third, there may be information in the narrative section of the registration which should be cross-referenced in the financial section, or vice versa. Fourth, in Statement on Auditing Procedure No. 25, the AICPA Committee on Auditing Procedure sets forth its views to the effect that a reasonable investigation would include the reading of the full text of the prospectus and review of pertinent portions of the rest of the registration statement.

The lawyer's review of the financial section is also helpful in producing a good registration statement. First, certain information concerns the members of both professions—litigation, for example. Similarly, the information in notes to the statements may deal with restrictions arising out of loan agreements, indentures, or the company's charter. The statement note is usually brief, and the accountant will want to be sure that the brief note is satisfactory to counsel. Second, sometimes the financials disclose briefly the provisions of certain material contracts. Inasmuch as the contracts, in all likelihood, were drawn up in the first place by lawyers, they are the ones most qualified to review and approve the condensed version appearing in the financial notes. The same can be said of the notes relating to pension plans, stock option plans, and deferred compensation plans, with all of which the lawyer is very familiar.

Pooled Investments of Nonprofit Organizations

By Ernest W. Baldassare, CPA

Many nonprofit organizations have been changing from the book-value basis to the market-value basis as a method for operating a pool of investments. The author compares the two methods as to results which may be achieved and as to their relative advantages and disadvantages. Likewise considered are the problems involved in changing from book value to market value.

Authoritative literature on the subject of investment management for nonprofit organizations encourages the use of investment pools rather than separate investments for each fund, and regards both the book-value and the market-value methods as acceptable methods for operating the pool.

We will not attempt to discuss in detail the merits of pooling investments of funds, or the legal problem of whether specific funds may participate in an investment pool. The advantages of pooling are well known and clearly established; the pooling concept permits greater diversification of investments and minimizes the amount of uninvested cash of each participating fund. The concept has achieved general acceptance for the management of investments of funds of nonprofit organizations, except for those funds whose terms do not permit the pooling of their assets with those of other funds. In the interest of brevity, therefore, we will accept the concept of pooling, and confine our discussion to a comparison, as an aid to evaluation by the reader, of two concepts for determining distribution of pooled investment income and of realized and unrealized gains and losses.

ERNEST W. BALDASSARE, CPA, is past chairman of our Society's Committee on Accounting for Nonprofit Organizations. Mr. Baldassare is a principal in the firm of Haskins & Sells, certified public accountants.

COMPARISON OF METHODS

Under the book-value method (which is probably the more widely used), each fund participating in the pool receives income based on the ratio that the principal of the particular fund bears to the total principal of participating funds and, if withdrawn, receives the principal amount of the fund and may receive a proportionate share of realized gains and losses.

Under the market-value method (which can be operated very similarly

to a common trust fund or a mutual investment fund), each fund receives income based on the ratio that the market value contributed by it bears to the total market value and, upon withdrawal, receives the principal amount of the fund plus or minus a proportionate share of realized *and unrealized* gains and losses.

This method presupposes the establishment of a new investment pool each time a fund is admitted to the pool or each time a withdrawal from the pool is made. It requires a market valuation not only of the securities to be added to the pool, but also of all securities held as investments of the pool. This results in unrealized gains and losses on securities held as investments of the pool being included in the formula for distribution of income.

Whether a pool is maintained on the market-value or the book-value method, the carrying value of the investments held as assets of the pool should be cost (or market value at the date of acquisition if acquired other than by purchase). Unrealized profits and losses, therefore, would not be recognized in the accounts under either method, although under the market-value method they would be used for the purpose of computing on memorandum records the participation ratios, units, or shares of the participating funds.

Under either method, undistributed realized gains and losses on investments may be established as a principal account so that, among other things, the book value of the participating funds will remain constant while they are invested in the pool. Also, under either method, the total investment income to be distributed to the participating funds may be budgeted in advance, based on forecasts of investment income, with the difference between the budgeted income and actual investment income being transferred to an account which may also serve to stabilize the distribution of investment income.

THEORY OF MARKET-VALUE METHOD

Early literature on the subject of market-value basis pools described the method in terms of weighted averages, index numbers, adjustment factors, and algebraic formulae. While operation of a pool on such basis may not have been as complicated as it appeared from its description, few institutions adopted the method, probably because it was so difficult to understand and — perhaps more important—to explain to donors. Later literature—that is, within the past ten years—relates the method to common trust fund procedures and has achieved a much more "saleable" product in that it is more easily understandable both to the administrators of the institutions and to donors.

The market-value method is based on the theory that each fund participating in the pool is in fact a shareholder in the pool. All funds in the pool are allotted units, as at the inception date, at the rate of one unit for each dollar (or other specified amount) of original contribution. Thereafter, incoming funds purchase new units in the pool at a price determined by dividing the total market value of the assets of the pooled funds by the number of units outstanding at the date of the new fund's admission (a procedure similar to the determination by a common trust fund or mutual investment fund of the price at which new units or shares are issued). Funds withdrawn from the pool receive amounts representing the market value of the units surrendered, rather than the actual number of dollars originally invested in the pool. It would appear that this is equitable,

since the withdrawing fund, in "selling" its units, receives its share of the change in market value during the period the units were held. As to the bookkeeping required on withdrawal, the difference between the withdrawal value of units surrendered and their related book value may be recorded in a principal account designated by a title such as "Redeemed Units—Surplus or Deficit." For statement purposes, this account may be combined with the account for realized gains and losses on investments.

COMPARISON OF RESULTS

While the book-value basis is probably the one used most widely, interest in the use of the market-value basis has been increasing in recent years. One of the main reasons for the increased interest is the substantial rise in the market quotations of common stocks in the last decade. Many institutions today are in the fortunate position of having investment portfolios with market values well in excess of book values, and with substantial amounts of realized gains on sales that have not been distributed to the participating funds. The result is that in a book-value basis pool, an incoming fund gets a "free ride" in that it gets the benefit of the market appreciation of the past several years. For example, assume a pool has been in operation for ten years and that total book value of the funds participating in the pool is \$1,000,000. Assume also that there have been no changes in the funds for the full period, that gains on sale of investments of \$100,000 have been realized which have not been distributed to the individual participating funds, and that today's market value of the pooled investments is \$1,500,000. Annual income on the pooled investments is \$60,000, which is 6 percent of book value, or 4 percent of market.

Let us suppose that the institution receives a \$300,000 grant, the income of which is to be used for a particular purpose. If the new fund is separately invested, it will produce income of, say, 4 percent or \$12,000. If it enters a book-value basis pool (and assuming the pool is not reconstituted at today's market because of materiality of the new fund), it will participate pro rata with the other funds in income earned, and also in eventual distribution of gains realized prior to its entry into the pool. Based on the above figures, annual investment income will now be \$72,000 (\$60,000+\$12,000), of which the new fund will be entitled to approximately 23 percent (\$300,000÷\$1,300,000), or \$16,500—\$4,500 more than if it were separately invested. (Income distributed to other funds, therefore, would be reduced from \$60,000 to \$55,500.)

If the new fund enters a market-value basis pool, it will receive 2,000 units, determined as follows:

Total current market value	\$1,500,000
Number of units in pool (\$1,000,000÷\$100)	10,000
Price per unit	\$150
Units assignable to new fund of \$300,000	2,000

We now have a pool with 12,000 units having a book value of \$1,300,000 and market value of \$1,800,000. Investment income of \$72,000 would be distributed at \$6 per unit (\$72,000 ÷12,000 units), which would entitle the new fund to \$12,000—the *same* as if it were separately invested.

In an opposite situation, a withdrawing fund in a book-value basis pool does not get the benefit of market appreciation. Never does it receive any portion of unrealized gains and, depending on the distribution policy of the institution, it may not receive its share of realized gains. Using the figures from the above example, a

$100,000 fund withdrawing from the pool would receive $100,000 on a book-value basis (or $110,000 if the policy of the institution is to distribute realized gains), but would receive $150,000 (1,000 units at $150) in a market-value basis pool—again the same as it would have received if the fund had been separately invested with holdings of exactly 10 percent of each pooled investment.

PROBLEMS IN INSTITUTING CHANGE

If an institution should decide to change from a book-value basis investment pool to a market-value basis pool, the most equitable method of allocating units to the participating funds would be to compute the units assignable to the funds participating at the inception of the pool, based on market values at that date (which, at inception date, is also book value), and to compute units assignable to subsequent additions based on market values in the applicable year. Funds participating in the pool, therefore, would be allotted a number of units determined by dividing the principal amount of the fund by the "price" of a unit in the year the assets of the fund were invested in the pool. The price would be one dollar (or other specified amount) for funds participating at inception, and, for later additions, a price computed as previously outlined.

If a book-value basis pool has been in operation for so long a time that a computation going back to its inception would be impractical, an alternate acceptable method might be to make the initial allocation of units as of the latest date when market value and book value of pooled investments were approximately equal.

There is some sentiment in favor of beginning a market-value basis pool by allocating units based on market values as of the date of change, on the theory that past injustices, if any, are permanently buried. There may be danger in this method, since it results in allocating unrealized gains pro rata among the participating funds, regardless of the length of time they participated in the pool. An institution should therefore obtain an opinion of legal counsel, based on a study of the terms and restrictions of the specific funds participating in the pool, as to whether this latter method would be in violation of the fiduciary responsibilities of the institution.

As to distribution of income, if the difference under the two methods is material, it would be appropriate to confer with legal counsel before deciding whether retroactive adjustment should be made of income previously distributed on a book-value basis. It is believed that, in most cases, redistribution of prior years' income would not be considered necessary.

If a market-value basis pool is adopted, valuations subsequent to date of adoption should usually be made more frequently than annually; a quarterly or, at most, a monthly computation would be sufficiently frequent for most institutions (as contrasted with a twice-daily computation by many investment trusts).

ADVANTAGES AND DISADVANTAGES

The book-value method has the advantage of simplicity; further, where changes in the funds participating in the pool are not significant, inequities that might result from the use of this simplified method are usually insignificant. On the other hand, where there are significant additions to, or withdrawals from, the funds participating in the pool (which usually results when funds both expendable and non-expendable as to principal participate), and where there is a material difference between market value and cost of the investments held, the

market-value basis generally insures a more equitable distribution of income and of principal when funds are withdrawn.

One of the most frequently voiced objections to a market-value basis pool is the additional clerical work required and the resulting increased cost of operations. In my experience with institutions that have studied the problem and decided to make the change, once the initial allocation of units has been resolved, the additional clerical work of maintaining a market-value basis pool is negligible.

A practical, rather than theoretical, objection to the market-value method results from the fact that in a rising market (as illustrated in the example above), distribution of income to a fund entering an existing book-value basis pool is usually higher than it would be under the market-value method. Administrators of an institution, who are appropriately interested in attracting additional funds for the institution's use, may therefore prefer to offer to new funds the advantage of the higher rate of return presently resulting from the use of the book-value method.

Critics of the market-value method also point out that while the method may be equally appropriate for common trust funds and for funds of nonprofit organizations, there are fewer instances in which nonprofit organizations find the market-value method necessary for their purposes, principally because of certain basic differences in the composition of the participating funds. They point out that every common trust fund must terminate at some time, but that endowment funds are established in perpetuity, so that withdrawals from an endowment fund's investment pool would be rare. Common trust funds' investment pools must provide for current distributions of principal as well as of income, while endowment funds' investment pools need provide only for current distributions of income. They also point out that participants in a common trust fund are unrelated except as to their investment, while participants in a pool of a nonprofit organization usually are all dedicated to the broad corporate purposes of the institution.

FACTORS TO BE CONSIDERED

Before an institution decides whether to change the operation of its investment pool from a book-value to a market-value method, many factors should be considered, among the most important of which is the composition of the funds presently participating in the pool. If a pool is a pure endowment fund pool, withdrawals would be quite infrequent and allocation of unrealized gains or losses would be relatively unimportant. If all of the income earned by the pool may be used for general purposes (or for restricted purposes where such income covers only a portion of total expenditures for such purposes), there may not be any significant reasons for making the change. On the other hand, where a significant portion of the restricted income of the pool is to be expended for purposes that would not normally be appropriated from general funds (as, for example, for life income beneficiaries or for specific projects that would not otherwise be undertaken), a market-value basis might be more appropriate.

Authoritative literature relating to investments of universities recommends that investments of different fund groups—that is, current, loan, endowment, or plant funds—should not be commingled in the same investment pool. Institutions following this recommendation often find, after study of the market-value method, that since there is relatively little change in the

composition of the funds participating in the pool, the advantages of a market-value basis pool are not sufficiently great to outweigh what is often considered to be its principal disadvantage —additional clerical work, particularly at inception.

Nevertheless, many institutions, including universities, do commingle the investments of the fund groups (or permit funds temporarily functioning as endowment to participate in an endowment fund's pool), and this often results in material changes in the funds participating in the pool. Such institutions may find, after appropriate study, that the market-value basis pool is preferable for their purposes.

CONCLUSION

To summarize, distribution of income and of gains and losses under the market-value method cannot be inequitable, while distribution under the book-value method may or may not be equitable, depending upon the circumstances. Further, even in situations where distribution on a book-value basis is equitable (as, for example, where only permanent funds participate in the pool and where all income may be used for general purposes), the market-value basis pool affords assurance of continued equitable distribution in the future, should events occur that might create an inequity (such as receipt of a new fund whose income can be used only for a specific purpose).

For these reasons, if a pool is being initiated today, serious consideration should be given to the market-value basis. However, where a pool has been in operation for a number of years on a book-value basis (which is frequently so), the institution should study the situation carefully and should usually not change to a market-value basis unless the results of the study indicate that inequities which may be caused by the simplified book-value basis are significant.

Clarity in Internal Reporting

One of the most disappointing aspects of present-day reporting is that, although the right information is available, it often is not presented in a simple, clear, meaningful form which leaves nothing for the manager to do but make an evaluation and take action. Either it is impossible to interpret a report correctly, or the effort required to do so is prohibitive. . . .

Clarity is missing because there is the erroneous assumption on the part of many today that the more information management receives the better off it is. Many reports contain an indigestible amount of information in the form of too many columns and irrelevant or excessive detail. One of the most common causes of this condition is the attempt to make a report serve too many purposes. Another is the failure to draw the distinction between that information which should appear in regularly issued reports and that which should be held in reserve for special analysis and study.

ALEX G. RANKIN, "Making Reports Truly Current," THE CONTROLLER, June 1960

Society Trial Board Decisions

In recent months the Trial Board of the New York State Society of Certified Public Accountants has held a number of hearings on complaints against members for violations of the Rules of Professional Conduct. The decisions are indicative of the strong emphasis being placed on the enforcement of professional discipline. Names and dates have been deleted to preserve the confidential nature of the Trial Board proceedings. The Board of Directors in accordance with the bylaws and Society policy has ordered the publication of these decisions for the information of the members.

CASE NO. 1

Complaint. A member appeared before the Committee on Professional Conduct with reference to a complaint made by a printing company that he had retained certain records and tax returns. He agreed to make the documents available to the company. It was alleged that the promises were never carried out.

Answer. In a letter, the member stated that he had made the records in his office available to the company and that someone from the company had gone through the files and removed certain papers therefrom.

Trial held. The member did not appear and was tried *in absentia.*

Decision. Found guilty of having failed to comply with promises made before the Committee on Professional Conduct and by so doing violated the Rules of Professional Conduct and the bylaws of the Society in that his actions are incompatible with the obligations and responsibilities imposed by his professional status and by his membership in the Society. The member was suspended from membership for a period until such time as he will furnish proof that he has fulfilled his promises.

CASE NO. 2

Complaint. The Committee on Professional Conduct wrote to the member on three successive dates informing him that a client of his had filed a complaint concerning the filing of certain tax returns. He did not answer any of the letters.

Answer. The member responded that since he had returned all the client's files he did not feel it necessary to reply to the Society's first two letters and he denied having received the registered letter sent to him by the Society. He further stated that certain of the records requested by his former client had been lost as a result of an automobile accident.

Decision. Found guilty of having failed to answer two communications from the Committee on Professional Conduct and thereby violated the Rules of Professional Conduct and the bylaws of the Society in that his actions are incompatible with the obligations and responsibilities imposed by his professional status and by his membership in the Society. Suspended immediately from membership for a period of six months.

Appeal. The Secretary of the Society was served with a notice of appeal from the decision. The Board

of Directors, after review of the proceedings, modified the decision of the Trial Board so that the appellant's membership was not suspended. However, he was strongly censured for his unprofessional conduct in disregarding letters from the Committee on Professional Conduct.

AK 9/60

CASE NO. 3

Complaint. A member was asked to assist in the preparation of an application for a loan from a governmental agency. It was alleged that he prepared certain statements that were false and misleading in that in a Comparative Statement of Income, Profit and Loss, gross income was overstated in a relatively material amount and on the Statement of Financial Condition an overdraft of a substantial sum was not shown and real estate was shown at its insurable or replacement value rather than at cost. It was further alleged that these statements were delivered to the lending agency in his presence under such circumstances as would lead that agency to believe that the statements were prepared by the member. It was alleged that the member wilfully violated Rule 1 of the Rules of Professional Conduct in that he rendered professional services under terms and circumstances discreditable to the profession.

Answer. The member responded that the completed application for the loan with balance sheets and financial statements annexed although prepared by him were not signed or certified to by him but were signed by one of the clients. The loan was never approved. The member stated that the loan agency was aware he had not signed the report. He further stated that after a hearing before the Committee on Grievances of the University of the State of N. Y., the Board of Regents censured and reprimanded him.

Decision. Found guilty as charged and censured. Membership in Society suspended for two years but such suspension of membership held in abeyance unless further complaints are made against him in the two-year period. In case of further misconduct the two-year suspension will become effective plus any other sentences imposed as a result of subsequent decisions of the Trial Board.

CASE NO. 4

Complaint. A member certified as correct to a governmental agency a financial statement for a manufacturing company client. A copy of the statement was filed also with another agency. It was alleged that the statement failed to include certain assets of the company contained in a bank account and therefore was false. It was alleged that the member committed acts discreditable to his profession and in violation of Rule 5, Subdivisions (a), (b), (c), (d), and (e) of the Society's Rules of Professional Conduct and the bylaws of the Society and his actions were incompatible with the obligations and responsibilities imposed by his professional status and his Society membership.

Answer. The member denied the allegations and stated further that similar charges were heard before the Department of Education and were dismissed.

Decision. Not guilty of having failed to include in a statement of the company which he certified as correct, certain assets contained in a bank account. Not guilty of having certified and issued said statement with full knowledge of its falsity and inaccuracy. Guilty of having issued and certified said statement without properly examining the records of the company and

in so doing committed an act discreditable to his profession. The Trial Board therefore censured and reprimanded him.

CASE NO. 5

Complaint. The Committee on Professional Conduct received a complaint from two individuals alleging that a member had failed to furnish copies of tax returns to them. They were former clients. The member was so advised by mail and was asked to respond to the Committee. He failed to answer several communications from the Committee on Professional Conduct.

Answer. The member claimed that illness in his immediate family prevented his attention to the request to furnish his former clients with tax return copies. He claimed that the client had been informed he could have copies on request but that he had not requested them until the period when the illness of the member's wife required him to stay at home.

Trial held. The member did not appear and was tried *in absentia.*

Decision. Found guilty of failing to respond to three requests of the Committee on Professional Conduct. Suspended from membership for a period of six months.

CASE NO. 6

Complaint. It was alleged that the member wilfully violated Rules 9 and 10 of the Society's Rules of Professional Conduct which forbid a member from soliciting clients by circulars or advertisements which were not requested and not warranted by personal relations, and further forbid a member from advertising his professional attainments or services or from publishing in a newspaper what is technically known as a card exceeding two columns in width.

Answer. The member denied having authorized the newspaper advertisement in a format other than that permitted by the Rules. He did admit to the alleged distribution of circulars.

Decision. Found guilty of soliciting clients by the distribution of announcements to persons with whom he had no existing personal or professional relation. Suspended from membership for a period of three months.

Portrait of a Controller

He is the man who puts the hard foundation of reality under the gossamer fabric of your dreams. He is the corporate conscience and the business taskmaster, the engineer who charts the path to profits and turns the vision of the good life into the real thing.

It's not always a daisy-strewn road that he leads you down, but he sees that you get there. When you stumble he picks you up, and when you lag he prods you on. Sometimes he pushes you to the limit of your endurance. But somehow he gets you there in the end. Come to think of it, you need a man like him around.

What would you do without him?

DUDLEY E. BROWNE, "Today's Challenges to the Controller," THE CONTROLLER, June 1960

Operations Research Applied to Business Problems

By DAVID B. HERTZ

OPERATIONS RESEARCH AND COST DETERMINATION

COST to the layman may be a simple matter. He may believe that it begins and ends when he is told the price of an item and makes payment therefor. He may not look deeply into what his car "cost" him or into the real (but possibly hidden) costs of operating his car. In industrial operation costs are essentially operating variables used for predictive and control purposes. Some of these costs are readily and "accurately" obtained. The costs of many basic quantities are difficult to arrive at. Often, required operating costs are not even directly measurable and can only be inferred from other cost determinations. Furthermore, many costs which *can* be measured can only be established statistically, since these costs vary considerably, and repeated measurement yields differing results.

A simple example is the labor cost for a certain phase in a manufacturing operation. In the first place, if there is more than one worker performing the operation, their rates of pay may not be the same. Then, of course, their rates of production (or rather, average rates of production) may not be the same. Certainly, the production rate of the same worker varies from day to day, from morning to afternoon, and even from hour to hour. Again, in batch production, the setup costs differ from time to time. Hence, if a producer of 500-foot rolls of 30-inch wide XXB paper is asked to provide 500-foot rolls of 45-inch wide XXB paper, he knows in advance that the cost is not likely to be exactly one and one-half times the cost of 30-inch rolls. He thus may be called on to predict the cost of an item with which he is familiar, but which he may not have made in quite that way before. He must have the conviction that he can consistently produce the "same" thing at a relatively constant unit cost. He must also believe that the parameters, which enter the formula for this unit cost of the item which he has been making, can be used to predict the unit cost of a similar item made under somewhat different conditions. One can conjure up an interminable number of examples and one can discuss at length the varied and subtle ramifications of cost measurement and prediction. For practical usefulness it is best to study some typical cases and perhaps distill from the results some techniques which may have a wide range of applications.

DAVID B. HERTZ is Principal in charge of Operations Research for Arthur Andersen & Co. He holds a Ph.D. degree from Columbia University and has served in various executive positions in industry. Dr. Hertz has been Associate Professor of Industrial Engineering at Columbia University, and still serves there as Lecturer in Operations Research.

ED. NOTE: Part one of this article appeared in the August 1960 issue.

EXAMPLES: CORRELATION OF LABOR COST WITH PRODUCTION

The job shop manufacture of metal tubes is performed in three major departments: (1) Hot Bending, (2) Pressure Welding, and (3) Assembly. These three departments account for the major part of the direct manufacturing costs of the product; raw materials entailed in making the product and overhead are not included for present discussion. Suppose management wishes to estimate the cost contributed by each of these three departments to the unit manufacturing cost of the product. We may examine the historical data of costs given in the tables in Figure III, where the standard production hours and actual payroll expense are shown for each department. Can management infer from these data unit labor costs for other work loads? The data for a number of weeks of operation are then plotted for each department in terms of Payroll Expense versus Output in standard labor hours in Figures IV, V and VI. Assuming this form of the information as valid, can management infer the unit cost of labor for this product?

Perhaps we should first ask how many pieces are to be produced weekly and then convert that number into the number of standard hours required. For example, hot bending 10,000 parts a week may require 4,000 standard hours. What is the manufacturing payroll expense per unit for 10,000 parts per week? Incidentally, a Standard Labor Hour is expressed in terms of the number of items (in this case the number of hot bends performed) specified to be produced in an hour at standard rate of pay. Some workers can produce at only 90 percent of the standard rate and yet are paid standard pay. Others produce above standard and are paid bonus. Hence, from day to day and week to week *the actual expense per standard labor hour per worker* can vary considerably. If the workers are learning a new job we cannot make accurate predictions; we must wait until they have settled down to steady production. On

FIGURE III

COST DATA

WEEK	-1- HOT BENDING		-2- PRESSURE WELDING		-3- ASSEMBLY	
	PAYROLL EXPENSE	STANDARD HOURS	PAYROLL EXPENSE	STANDARD HOURS	PAYROLL EXPENSE	STANDARD HOURS
1	$ 8250	2800	$ 6500	5000	$ 4000	1000
2	10000	3000	6500	5500	3200	2750
3	15000	5300	8000	6000	3500	2000
4	20750	6800	8700	8500	5000	1750
5	20000	6000	6500	7500	2500	1000
6	22500	7000	7500	6700	4500	1500
7	18750	6300	8700	7500	3000	0750
8	13750	5700	7500	7200	4500	1250
9	22000	7800	6000	6000	3750	3000
10	8250	2900	6000	3000	1500	0500
11	9500	3700	4000	2500	3000	2500
12	8750	2500	4000	2800	4500	2000

the other hand, we may hope that the different variables, individual variation in rate of output, variation in defectives, equipment break-down, variation in materials and material flow will combine to produce random variation in the number of standard labor hours required for a standard operation in a given department. In that event, that is, if the various aspects of the operation in a given department can be expressed by stable statistical measurements, then it may be that the payroll expense will vary as a simple linear function of standard labor hours of production.

Let us again examine Figure III. There is no observed value for 4,000 standard hours; we try the nearest to it, 3,700, for which the cost is $9,500 or $2.57 per standard hour. There is also a value for 3,000 standard hours, $10,000 or $3.33 per standard hour, which is quite a difference. But at 2,900 standard hours the cost is $8,250 or $2.84 per standard hour. What is reasonable for management to do in the face of these apparent inconsistencies?

Let us see if there is *real* inconsistency among these costs or whether the variations may be characterized by statistical consistency. We will calculate all of the hourly costs and give them a hard look. First we tabulate:

Standard Labor Hour Cost
Hot Bending

Weekly payroll	Hours per week	Standard labor hour cost
$ 8,750	2,500	$ 3.50
8,250	2,800	2.95
8,250	2,900	2.84
10,000	3,000	3.33
9,500	3,700	2.57
15,000	5,300	2.83
13,750	5,700	2.41
20,000	6,000	3.33
18,750	6,300	2.98
20,750	6,800	3.05
22,500	7,000	3.21
22,000	7,800	2.82

Average Standard Labor Hour Cost = $2.985

Now let us see whether the different hourly costs are as inconsistent as they seemed before. The average of the twelve values is $2.985 per standard labor hour. Thus, in six of the weeks the costs are less than the average, while in the remaining five weeks they are equal to it or above. This does not seem statistically unreasonable. Does this value, $2.985, then satisfactorily represent *the* standard labor hour cost? Perhaps not, since there are deviations of as mu h as 50 cents. But we may be able to e ress the weekly payroll expense as a fu tion of the number of standard labor hours of output in a week. The weekly payroll expense seems to be proportional to the weekly output in standard labor hours, as we well might expect. The relation between payroll and output also seems to be linear, and if we have good technical reasons to believe in such a linear relation we may try to fit a straight line to these data.

Fitting a Straight Line to Data

There are many ways of fitting straight lines to data. The method of least squares has good practical justification —and also good theoretical support. In this method, if a variable "x" is known accurately and a variable "y" is supposed to vary in a random manner about a true average determined for each x, then there is a *systematic* way for determining two constants, "a" and "b" of the elementary algebraic equation of a line:

(1) $$y = ax + b$$

which may be used to represent the observed values. For each observed pair of values (x_i, y_i), (x_2, y_2), etc., we find the corresponding value y_i from equation (1), for $x = x_i$. Then we subtract the latter value from the observed value and get a difference, d_i. Then we adjust a and b so as to minimize the sum of the squares of these differences:

(2) $$d_1^2 + d_2^2 + \ldots\ldots + d_n^2$$

This will yield two simple algebraic equations which we can solve for a and

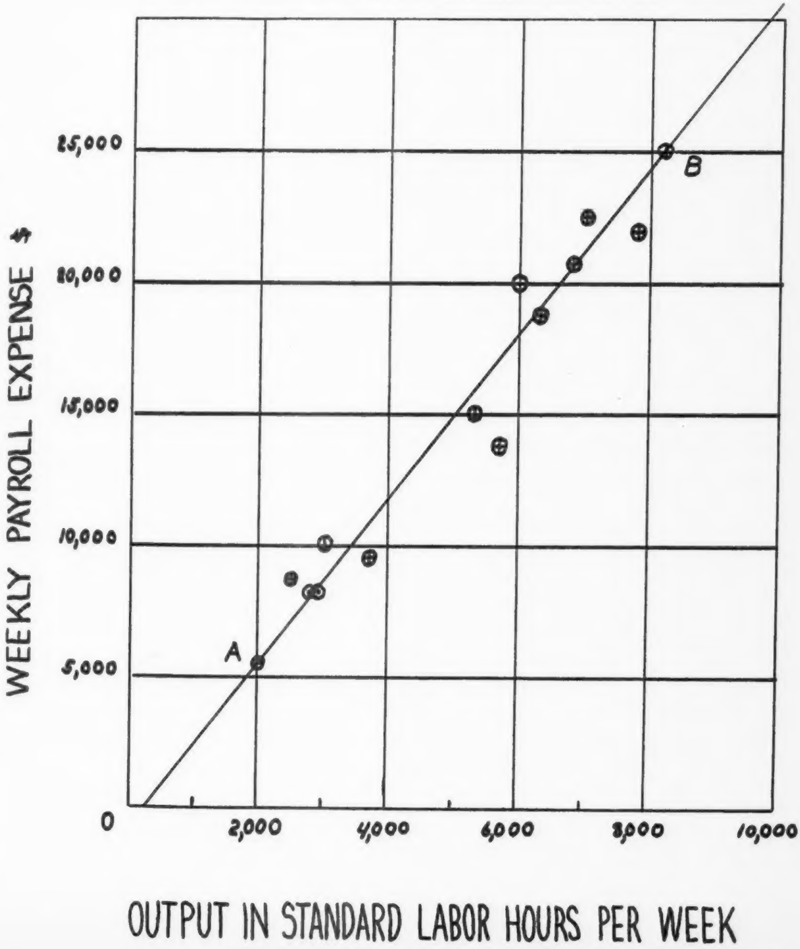
b, yielding the estimated equation of the line. This line is called the least squares line because the sum of squares in (2) is minimized. For the present we will not formally find the regression line by the method of least squares, but we will take advantage of a quick approximation technique in order to gain insight into the meaning of "fitted" straight lines.

As noted above, the data of Table 1, Figure III, is plotted in Figure IV. Then by inspection we draw a line $\overline{AB}$ which seems best to represent the twelve plotted points. We will first find the equation of this line and then estimate some standard labor hours from this line in order to determine how "good" it is. We find the coordinates of the two selected points *A* and *B* and form the following table:

FIGURE IV

HOT BENDING

PAYROLL EXPENSE VS OUTPUT IN STANDARD LABOR HOURS



Point	x(hours)	y(cost)	Standard labor hour cost
A	2,000	\$ 5,250	\$2.625
B	8,200	25,000	3.048

Then substituting these coordinate values for x and y in $y = ax + b$, we have:

$$(3) \qquad \begin{aligned} 5{,}250 &= 2{,}000a + b \\ 25{,}000 &= 8{,}200a + b. \end{aligned}$$

Solving equations (3) we obtain

$$(4) \qquad \begin{aligned} a &= 3.185 \\ b &= -\,1{,}120 \end{aligned}$$

and thus our line AB is represented by

$$(5) \qquad y = 3.185x - 1{,}120.$$

Thus for a given value of standard labor hours per week, x, we find the payroll expense, y. Then solving for $\frac{y}{x}$ we have

$$(6) \qquad \frac{y}{x} = 3.185 - \frac{1{,}120}{x}$$

where $\frac{y}{x}$ is the standard labor hour cost estimated for a particular number of standard labor hours from equation (5). Below is a table of values of x, y, and the corresponding unit standard labor hour cost for selected values of x covering the range of observed values of weekly output in standard labor hours:

WEEKLY PAYROLL AND STANDARD LABOR HOUR COST

Computed from $y = 3.185x - 1{,}120$

(Observed values in parentheses)

x = Hours per week	y = Weekly payroll	y/x = Standard labor hour cost
2,500	\$ 6,842 (8,750)	\$2.737 (3.50)
3,000	8,435 (10,000)	2.812 (3.33)
3,700	10,664 (9,500)	2.869 (2.57)
5,300	16,880 (15,000)	2.984 (2.83)
6,000	17,990 (20,000)	2.998 (3.33)
7,000	21,175 (22,500)	3.025 (3.21)
7,800	23,723 (22,000)	3.043 (2.82)

Note that the range of computed standard labor hour costs for the observed range of weekly output, is \$2.737 to \$3.043, or 30.6 cents. This variation is much less than the \$1.09 variation of the original data. Even though, or perhaps just because, the hourly costs obtained from the regression line have a narrower range of variation, they may be used for predictive purposes. In fact, these results may provide an incentive to management to make costs more consistent. Certainly, it makes better sense to have hourly costs vary in some steady manner rather than irregularly and so widely as do the observed costs. For example, it would not seem to be good business practice to use for estimating a unit labor cost of \$2.57 in one case (expected 3,700 hour weekly output), and \$3.33 in another estimate (expected 6,000 hour weekly output).

The observed weekly payroll expense clusters fairly close to the line we have drawn and, interestingly enough, the observed average hourly cost of \$2.985 is close enough to the average computed cost of \$2.890. Hence, in cases like the present one, a simple regression analysis of the costs considered could prove to be very valuable for estimating future jobs.

Another fact may concern us. Looking at the observed hourly costs, we note that they increase with increased weekly output. The estimates from equation (6) also exhibit a similar trend. This seems to be contrary to other production experience. The facts cannot be denied. This increase in hourly cost with load may be explained in terms of the peculiarity of this job shop or it may result from uneconomic scheduling, high setup costs and too much overtime. In any case, the specific nature of the line given by equation (6) suggests an examination by management of the technical effectiveness of this department's operations. Fitting straight lines (even by inspection) can indeed provide a useful tool in cost determination and analysis.

HOW GOOD IS THE "FIT"

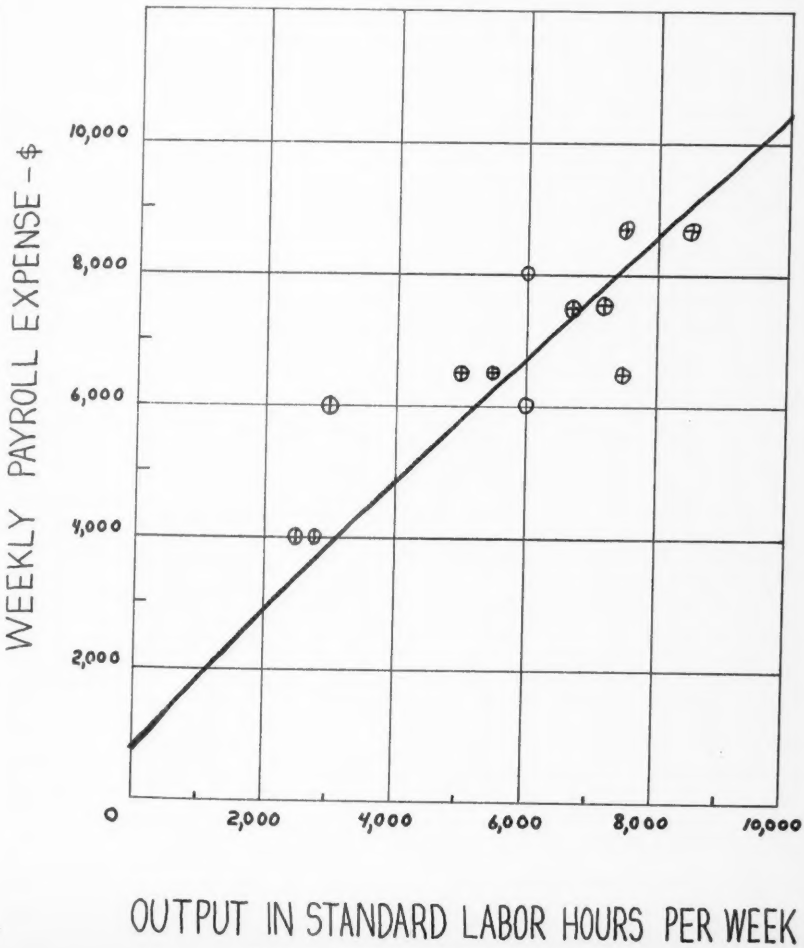
We may ask, how "good" is the "fit" of the line AB. Do the observed values spread too widely about the line to make it statistically useful to us? We can test this by means of "the correlation coefficient" as we shall see when we consider costs for the Pressure Welding Department.

Let us turn to another problem in cost determination by both the Hot Bending Department and the Pressure Welding Department data given in Figure III. It may be worthwhile to determine the least squares regression lines, $y = ax + b$, where y represents weekly payroll expense and x represents weekly output in standard labor hours,

FIGURE V

PRESSURE WELDING

PAYROLL EXPENSE VS OUTPUT IN STANDARD LABOR HOURS



this time in terms of the minimization of the sum of the squares of the deviations of the actual data from the line to be determined. It is simpler to work this out as follows, letting:

(7) $$y = a(x - \bar{x}) + b$$

where $\bar{x} = (x_1 + x_2 + \ldots . + x_n)/N$

and $\bar{y} = (y_1 + y_2 + \ldots . + y_n)/N$

where the set $(x, y,)$ consists of the observed paired values of the variables represented by x and y. We will not present the theory here, but merely the formulas for calculating a and b. They are

(8) $$b = \bar{y}$$

$$a = \sum_{i=1}^{N} (x_i - \bar{x})\, y_i \div \sum_{i=1}^{N} (x_i - \bar{x})^2,$$

$\sum\limits_{i=1}^{N}$ merely being a shorthand way of indicating summation for each one of the pairs involved (N altogether).

This formula for a happens not to be convenient for computation and can be replaced by:

(9) $$a = \left[\sum_{i=1}^{N} x_i\, y_i - N\,\bar{x}\,\bar{y}\right] \div \left[\sum_{i=1}^{N} x_1^2 - N\,\bar{x}^2\right]$$

First we give the result for the Hot Bending Department, as calculated in Figure VII:

(10) $$y = 2.92\,(x - 4{,}983) + 14{,}792 = 2.92x + 242$$

If you plot this line on Figure IV, you may find it difficult to distinguish the least squares line from the line put in by inspection. The regression line for the Pressure Welding Department costs is:

$$y = 0.669x + 2{,}856$$

Comparing Figures IV and V, we note that the points for Hot Bending adhere much more closely to their fitted line than do the points for Pressure Welding to their line. One might say that for Pressure Welding the regression line is not so good—or so close—a fit to the data as is the line for Hot Bending. There is a statistical measure for this closeness of fit; namely, the coefficient of linear correlation. This quantity, designated by r, measures the amount of variation of the original points from their least squares regression line. Let us calculate this quantity, or better, r^2 for each regression line and compare them.

The results are:

Hot Bending:

$$y = 2.92x + 242;\; r^2 = 0.931$$

Pressure Welding:

$$y = 0.669x + 2{,}856;\; r^2 = 0.742.$$

For Hot Bending an r^2 of 0.931 represents rather good linear correlation. The value of 0.742 for Pressure Welding gives less assurance that this regression is useful for predictive purposes (a perfect fit would give an $r^2 = 1.00$; an absolute "non-fit," 0). The latter values are not as highly correlated as might be desired and therefore should give management doubts about the accuracy of estimates made from the equation. This result might initiate an engineering investigation in order to improve the relationship between payroll cost and output in standard labor hours in Pressure Welding. It might also be worthwhile to check up on the data-gathering procedures. Such a simple analysis, using linear regressions and correlations, can assist an industrial organization in tightening up on both its technical and fiscal controls.

A more variable case is given in Table 3 of Figure III, for Assembly, plotted on Figure VI. There seems to be little or no correlation between payroll expense and output. Clearly management undertakes a hazardous task when estimating future Assembly jobs. One does not need to calculate r^2 to make a

decision about our inability to forecast based on past performance in this department.

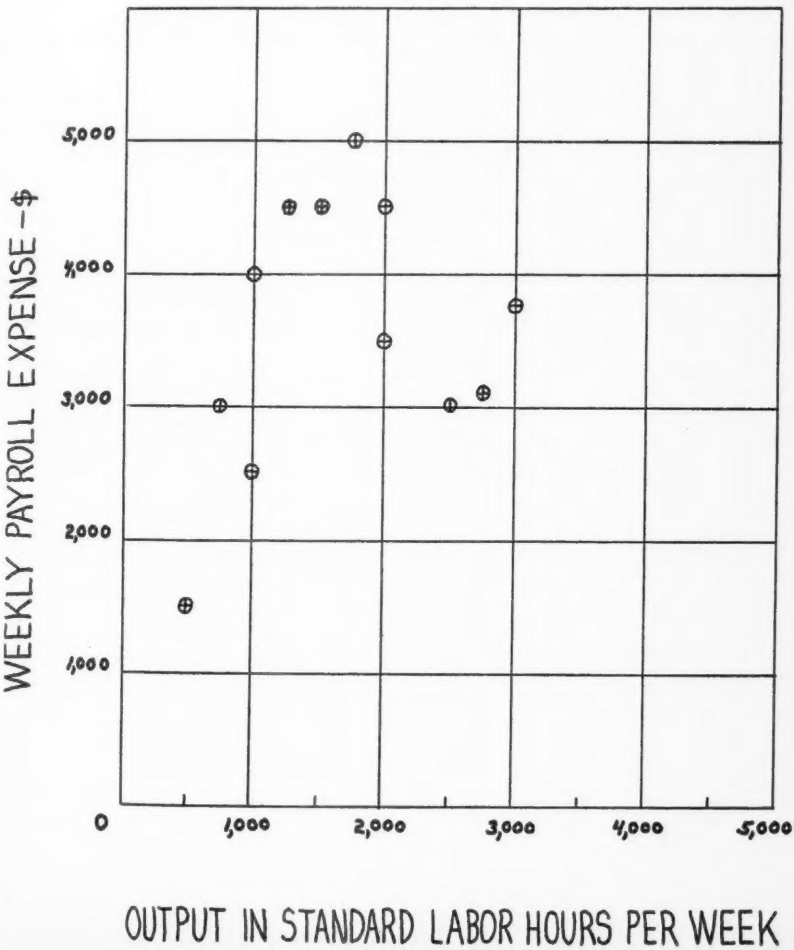
EXAMPLE OF REGRESSION APPLIED TO VARIABLE PRODUCTION SCHEDULE

Figure VIII presents an interesting situation where linear regression—straight line approximation—is essential in order to give predictive meaningfulness to data. With variations in workload, the plant represented by these data operates on a varying workweek of from 3 to 7 days. Operating expenses obviously vary with the number of days in the workweek. We would like to estimate the

FIGURE VI

ASSEMBLY

PAYROLL EXPENSE VS OUTPUT IN STANDARD LABOR HOURS



weekly expense as a function of weekly production. Hence, a difficulty arises in comparing expenses occurring in weeks of differing numbers of workdays. The cost data must be obtained, however, under conditions as they occur. In Figure VIII a number of observations have been made at 4, 5, 6 and 7 day operation. For a workweek of a given number of days there have been observed high and low production for the same expense, and varying expense for the same load. Hence, the cross-hatched region will include most of the actual costs. As the plant shifts from a seven-day week to a six-day week because of load decrease,

FIGURE VII

Regression Calculation Form

CALCULATION : REGRESSION LINE $y = a(x - \bar{x}) + b$
DEPARTMENT : HOT BENDING
VARIABLES : x = OUTPUT IN STANDARD LABOR HOURS
y = WEEKLY PAYROLL EXPENSE

N	(1) x	(2) y	(3) xy (000)	(4) x^2 (000)	(5) y^2 (000)
1	2800	8250	23100	7840	68062
2	3000	10000	30000	9000	100000
3	5300	15000	79500	28090	225000
4	6800	20750	141100	46240	430562
5	6000	20000	120000	36000	400000
6	7000	22500	157500	49000	506250
7	6300	18750	118125	39690	351562
8	5700	13750	78375	32490	189062
9	7800	22000	171600	60840	484000
10	2900	8250	23925	8410	68062
11	3700	9500	35150	13690	90250
12	2500	8750	21875	6250	76562
SUM	59,800	177,500	1,000,250	337,540	2,989,375

$\bar{x} = 4{,}983 \qquad \bar{y} = 14{,}792$

$\text{SUM}(3) - N\bar{x}\bar{y} = 1{,}000{,}250{,}000 - 884{,}502{,}432$

$\text{SUM}(4) - N(\bar{x})^2 = 337{,}540{,}000 - 297{,}963{,}468$

$$\frac{\Sigma xy - N\bar{x}\bar{y}}{\Sigma x^2 - N(\bar{x})^2} = a = \frac{115{,}747{,}568}{39{,}576{,}532} = 2.92$$

$$b = 14{,}792$$

$$y = a(x - \bar{x}) + b = 2.92(x - 4{,}983) + 14{,}792$$

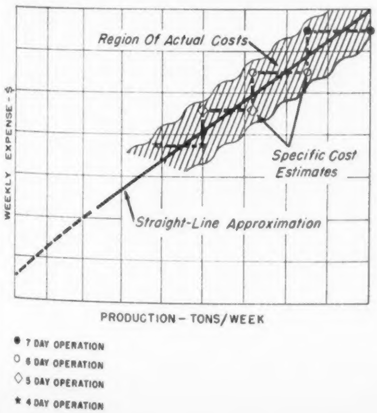
$$= \underline{2.92x + 242}$$

expense drops. But it is possible for expense to drop different amounts on different occasions. The cross-hatched area, therefore, represents a region of observed actual costs, whose lower boundary might approximate a least-cost line, and the region above it the highest-cost region.

One may connect the plotted points by a broken line or step function, but this broken line would not contain the right information for cost estimating and other purposes. Hence, neither the lower boundary nor the broken line represents the true situation *all the time.* A better representation is to approximate the plotted points with a straight line which represents average cost conditions and is neither too low much of the time, nor too high much of the time. This linear approximation together with the shaded region provides an adequate means of estimating weekly expense for a given workload, for it indicates the number of workdays to be considered and the range of expense to be expected. The values on the line serve as a good estimate—the shaded region as a measure of the variability inherent in this estimate—and the actual points as an indication of the number of workdays which may be economically worked under varying conditions. Cost determination thus may serve the company's management as a useful tool in achieving objectives.

FIGURE VIII

STRAIGHT-LINE APPROXIMATION OF EXPECTED ACTUAL COSTS



EFFECT OF ACCURACY OF COSTS ON DECISIONS

Many technical-managerial decisions are dependent upon the accuracy of certain cost determinations. A well known example is found in determining economic ordering quantities for production runs, which was discussed in our first example. The variable cost affected by the ordering quantity can be represented as follows:

Let:

C_1 = cost of placing an order—a constant (cost of paper work, setup cost, other fixed costs associated with an order).

C_2 = carrying cost for a unit of item for one year.

D = yearly demand in number of units (note that we do not need here to deal with average daily demand).

Q = number of items per production run, order quantity.

The total variable cost, T. V. C., is given by:

$$(11) \qquad T.V.C. = \frac{C_1\ D}{Q} + \frac{C_2\ Q}{2}$$

For simplicity, it is assumed that average inventory is $Q/2$, that one never runs out of stock and that we are dealing here with one item. A minimum of $T.V.C.$ can be obtained from equation (11) through the use of elementary calculus as noted previously (by differentiating the right-hand side with respect to Q and setting the result equal to zero). This yields:

$$(12) \qquad E.O.Q. = \sqrt{2\,(C_1/C_2)\,D}.$$

This formula is very effective in many cases, provided that C_1 and C_2 are accurately determined, and also D. Suppose we let $C_1/C_2 = 3$, $D = 15{,}000$ units and $C_2 = 1$. We will compute the *T.V.C.* for these values from the formula and check this for various order quantities, and then for some assumed inaccuracy in the cost data:

$$E.O.Q. = \sqrt{2 \times 4.5 \times 10{,}000} = 300$$

$$C_1 D = 45{,}000$$

$$C_2/2 = 0.5$$

Q	C_1D/Q	$C_2Q/2$	*T.V.C.*
50	900	25	\$925
100	450	50	500
200	225	100	325
300	150	150	300
450	100	225	325
900	50	450	500

We note, as expected from the *E.O.Q.* formula, that the total variable cost is a minimum (\$300) at a Q of 300.

Suppose that, owing to poor estimate of demand and erroneous estimation of C_1, the following values are used:

$$C_1D = 20{,}000$$

$$C_2/2 = 0.5.$$

Then we obtain these results:

Q	C_1D/Q	$C_2Q/2$	*T.V.C.*
20	1000	10	1010
50	400	25	425
100	200	50	250
200	100	100	200
300	66.7	150	216.7
400	50	200	250
500	40	250	290
800	25	400	425

The minimum is erroneously estimated as,

$$E.O.Q. = \sqrt{2 \times 2 \times 10{,}000} = 200$$

Examination of the table of the correct values shows that by erroneously using for *E.O.Q.*, 200 units, the actual *T.V.C.* is \$325 instead of \$300. The difference could be a material percentage increase in operating cost. Where costs are highly variable and where values are used uncritically, opportunity exists for considerable inaccuracy of data. Statistical analysis of cost data helps trace error. Regression and correlation techniques are useful in disclosing inconsistencies in such data.

These examples are illustrations of the manner in which systematic, logical approaches can be applied to problems in any business. Simple as the problems considered may seem, the essential ingredients of the scientific approach have been included in the analyses of resulting costs and revenues. Any such procedures require implementation and should be developed in the light of specific circumstances in each case. It is only when systems have been provided to give management needed information that the profits available from these new methods can be reaped.

Accounting Theory and Subsequent Events

By Joseph A. Mauriello, CPA

Statement on Auditing Procedure No. 25 distinguishes between events occurring subsequent to the statement date which may require adjustment or annotation of the financial statements, and discusses the auditor's responsibilities for their examination and reporting. In this article, the author presents the accounting theory and underlying criteria which may be applied in determining whether a subsequent event calls for statement adjustment or annotation.

THE accountant's responsibility for reporting events subsequent to the balance sheet date has been effectively presented in Statement on Auditing Procedure No. 25, issued in October 1954 by the Committee on Auditing Procedure of The American Institute of Certified Public Accountants. The purpose of this article is to discuss the accounting theory applicable to certain of the conclusions on reporting and disclosure contained in Statement No. 25. These conclusions, which recognize that certain subsequent events may require either adjustment or annotation of the financial statements, stem from two sources in accounting theory:

1. Generally accepted principles to assure accurate reporting as at the balance sheet date and for the period ending on that date.
2. The standard of informative disclosure which recognizes that the balance sheet date is arbitrary, that the balance sheet has a forward-looking aspect, and that all information should be disclosed which is relevant to meaningful and reliable analysis and inference.

JOSEPH A. MAURIELLO, CPA, is a professor of accounting at New York University, Graduate School of Business Administration. Dr. Mauriello is author of *Intermediate Accounting*, and has been a contributing author to several accounting handbooks and accounting periodicals.

APPLICABLE ACCOUNTING PRINCIPLES

Where the impact of the post-balance sheet event or transaction affects net income and stockholders' equity retroactively to the period just ended, the principles operative to this end are the following:

1. Matching expense with revenue for the fiscal period under examination.
2. Placing losses in the year sustained.

Both the foregoing principles require that the accountant use the maximum information possible in determining the proper expense or loss for the period and the concurrent effect on assets or liabilities at the end of such period. Whether such information originates within the period or subsequent to the period is unimportant when viewed from the objective of achieving fairness in reporting.

The following are some examples of post-balance sheet information used in fairly stating the expense of the prior period.

Uncollectible accounts. Accounts proving uncollectible in the following period, no matter what the cause of uncollectibility or the time of origin of the cause, require an allowance for bad debts as at the balance sheet date for the purpose of (1) assessing expense against the revenue recorded in the year of sale, and (2) stating the accounts receivable at cash realizable value.

Deferred maintenance. Maintenance on equipment in the following period may be caused by intensive use of the equipment in the prior period. This deferred maintenance is set up at the balance sheet date for the purpose of (1) assessing expense against the revenue previously recorded, and (2) reflecting the current liability, which, though not reduced to a contract basis at the yearend, is inevitable and therefore requires recognition under the going concern convention.

Examples of post-balance sheet information used to register loss as at the end of the preceding period include the following.

Sale of fixed assets. This example relates to proceeds on sale of fixed assets which were segregated for sale as at the end of the preceding period. The proceeds are the measure of cash realizable value at which the asset is stated under current assets, and any excess of book value over such realizable value is treated as a loss of the prior period when the decision to sell was made.

Inventory clearance items. Proceeds on sale of inventory clearance items measure cash realizable value, and hence assure a correct measurement of loss in the writedown of inventory from cost to a lower market at the balance sheet date.

Judgment against the company. This example relates to a judgment rendered after the balance sheet date but stemming from an event or transaction prior to the end of the period. Such judgment is recorded as a current liability as of the balance sheet date and the loss is charged to the prior period.

PROBLEMS IN TREATMENT OF LOSS

In the examples of loss later presented, it is recognized that the objective is to place the loss in the period sustained. The subsequent act of sale, court decision, or other closed event merely confirms the pre-existing loss.

Where the closed transaction takes place after the balance sheet date and the actual loss proves materially different from the estimated loss recorded at the yearend, the adjustment of loss should be considered as applicable to the next period. Only where the information available was incorrectly used should the adjustment be treated as a retroactive correction of the loss previously recorded.

Where the loss stems from management decision, such as in the sale of inventory as a job lot, in the sale of fixed assets removed from normal use, in the sale of subsidiary stock, and in the discontinuance of a research project previously treated as an asset, such loss is applicable to the period just ended only where the decision producing the loss was made prior to the end of the period. Where the decision is made after the period-end, on the basis of newly developed circumstances, the loss cannot be applied retroactively to the statement date unless there are other indications of loss effective at such date. Examples of these indications of loss include reduced cash realizable value of inventory salable in the ordinary course of business, reduced utility value of fixed assets still in normal use, and reduced value of subsidiary stock (where car-

ried at cost) representing a permanent impairment in value. These evidences of loss would have required recognition at the balance sheet date; the subsequent disposal merely aids in accurately measuring the loss.

Losses produced by fire, flood, or other casualty after the balance sheet date cannot be considered as having an incidence at the balance sheet date. The reason is that the loss and the casualty are simultaneous events; the economic impact is instantaneous with the physical. In the previous examples, the economic loss was already present at the balance sheet date and subsequent transactions merely confirmed the loss and aided in its measurement.

Some authorities accept the position, as previously expressed, that post-balance sheet changes resulting from forces after the balance sheet date cannot have an impact on the prior fiscal period. Other authorities feel that if the item is operating in character, i.e., inventory, subsequent movements up to the date of the audit report should be considered as applicable to the prior balance sheet date.

Losses from valuation of assets presume that the lower values are enduring over the period of future sale or use. Thus, a writedown of inventory from cost to a lower market, when viewed fundamentally in accordance with the principles stated in Accounting Research Bulletin No. 43, presumes that the market value used is related to the cash realizable amount over the period that it will take to liquidate the inventory written down. Sales in the subsequent period will aid in arriving at a proper market, which may be at variance from the temporary market prevailing at the balance sheet date.

Where market fluctuates greatly, the market value at the balance sheet date has no particular significance. Important is the selection of the value corresponding to the general level of the series of prices after, as well as up to, the balance sheet date. Prices after such date are taken into account solely for the purpose of arriving at a valid price at the balance sheet date. Viewed in this light, use of post-balance sheet prices does not contradict a position that price declines after the balance sheet date imply losses for the following period.

A further pertinent point on losses is that they must be measurable within reasonable limits of accuracy. Disposal of assets or other closed event prior to the date of the report reduces previous estimates to fact. The factual value is then imputed retroactively to the balance sheet date so long as under generally accepted accounting principles the loss is assignable to the prior fiscal period. In the absence of reliable measures of value, whether based on post-balance sheet transactions or other objective indicators, the loss cannot be recorded. The condition of loss would be expressed in the form of a footnote to the financial statements pointing out that (1) the amount of loss was not readily determinable, and (2) if applicable, such loss in any event would not be material in relation to the stockholders' equity in the company.

THE STANDARD OF INFORMATIVE DISCLOSURE

Disclosure of post-balance sheet financial information by footnote applies to the following types of situations.

1. The item, economically, pertains to the prior period but generally accepted accounting principles prohibit expression in the body of the statement. This type includes: (a) Losses not accurately measurable, discussed previously; and (b) Gains on sales of assets, which are excluded as at the balance sheet date because the doc-

trine of conservatism prohibits the taking up of profits incident to valuation.

2. The item, economically, pertains to the subsequent period and affects the income and stockholders' equity in a degree that will affect the judgment of the reader of the statements. Examples are significant profits and losses on sales of fixed assets and subsidiary stock, moving costs, lease termination costs, and flood or other casualty losses in the subsequent period.

3. The item is in the form of a specific transaction in the subsequent period affecting debt or capital structure, as contrasted with profit and loss, and by nature has long-run implications. Examples are mergers, stock and bond issues, and stock and bond redemptions.

It can be seen that the footnote is used for items which pertain to the prior period but which cannot be included in the financial statements because of the operation of certain accounting principles; for items which clearly apply to the subsequent period; and for items which take the form of transactions which are concrete, but not creative of profit or loss.

Accountants have a tendency, with respect to the first two categories, to cite losses and exclude references to gains. This practice has its roots in the doctrine of conservatism. There is no reason, of course, to exclude gains, since material amounts of a favorable nature are just as important to proper statement interpretation as amounts which are adverse.

OMITTED POST-BALANCE SHEET INFORMATION

We have pointed out the types of post-balance sheet information which are given effect to in the body of the statements or by footnote. Finally to be considered is information which, while significant, is ignored in preparing the statements. This information is of a general character not subject to concrete measurement, and whose disclosure may produce erroneous judgments. The omission of this information is justified by the accounting dictum that financial statements must be meaningful and helpful to the various groups that use them and, where general information is subject to varying interpretation, disclosure can only be harmful. Accounting is essentially quantitative and, insofar as financial reporting is concerned, historical in character. To inject into the statements disclosure of general information whose final economic effects are immeasurable and conjectural is to make the accountant a commentator, and imposes on him the dangerous responsibility of disclosing policy changes and economic effects too broad to permit accurate judgment.

RESEARCH IN ACCOUNTING

Research in accounting, as in physical science, works with facts, but where physical science looks within the facts to discover the principle, accounting looks to the desired end result and is confronted with the necessity of developing, creating and defining principles best suited to achieve these ends. And what is the required end result? The end result is to express in terms of a common denominator, the whole complex network of elements which make up a business. In other words, the final goal is to provide accommodations for financial reporting which are in harmony with the requirements of the rapid developing and changing economy of our days.

HELENE M. A. RAMANAUSKAS, "The Nature of Research as Applied to Accounting," THE WOMAN CPA, June 1960

New York State Tax Forum

Conducted by PETER ELDER, CPA

CHANGES IN FEDERAL NET INCOME

Section 367 of the New York State Personal Income Tax Law requires that a report shall be filed with the Tax Commission stating changes in net income arising from an examination of a federal income tax return by the Internal Revenue Service; and that such report must be filed within ninety days after final determination of such change. Regulations Article 571-a restates this requirement, specifies that Form IT-115 is to be used in reporting changes in net income, and cautions that "the notification must be given by the taxpayer regardless of whether he believes any notification of his tax liability under Article 16 of the Tax Law will be required."

Several inquiries have recently been received concerning the necessity of complying with the above requirement as it relates to changes in federal net income for the calendar year 1958 or any fiscal year ending in 1959. The answer to such inquiries is contained in the following ruling issued on August 12, 1959 by the State Tax Commission:

"Various inquiries have been received as to whether taxpayers are required to report to the State Tax Commission notices of changes in federal net income for the calendar year 1958 or any fiscal year ending in 1959.

"Chapter 60 of the Laws of 1959 cancelled the tax imposed by Article 16 of the Tax Law on the net income of individuals for the calendar year 1958 or any fiscal year ending in 1959 but provided for the imposition of tax thereunder on net capital gain realized by individuals during such years. It authorized the State Tax Commission to require such returns with respect thereto as it shall deem necessary or appropriate. No change was made with respect to the personal income tax imposed on trusts, estates or individuals who died during such years, or the unincorporated business tax imposed by Article 16-A.

"Subdivision 2 of Section 367 of the Tax Law requires taxpayers to report to the State Tax Commission all changes in federal net income within ninety days. This section is also applicable to taxpayers subject to unincorporated business tax (Section 386-j of the Tax Law.)

"In view of the cancellation of tax on net income for the calendar year 1958 or any fiscal year ending in 1959, notices of federal changes in net income for such years are not required to be reported to the State Tax Commission unless the federal change relates to:

1. capital gains as defined in Article 16;

2. income of an estate, trust or taxpayer who died during such years;

3. income of a taxpayer subject to

PETER ELDER, CPA, is chairman of our Society's Committee on New York State Taxation. Mr. Elder is a member of the firm of Peat, Marwick, Mitchell & Co.

unincorporated business tax, or

4. distributive share of a taxpayer from a partnership which is subject to unincorporated business tax.

"Despite the foregoing, notice of federal change in the net income of any partnership which is subject to unincorporated business tax is required to be filed with the State Tax Commission."

PROFESSIONAL FEES PAID TO NON-RESIDENT EXECUTOR OR TRUSTEE

Suppose Mr. A, a nonresident of the State of New York is: (a) executor under a will of a New York decedent; (b) trustee of a testamentary trust of a New York decedent; and (c) trustee under an inter-vivos trust created by a New York resident. Assume also that Mr. A receives professional fees in each of the above capacities. Must he report such fees for New York State income tax purposes?

The above questions were considered by the State Tax Commission in a ruling issued under date of June 10, 1960. Reference was made to Section 351 of the Tax Law which imposes a tax on nonresidents on income derived from New York sources. It was also stated that "although in many instances the source of commissions paid to a nonresident executor or trustee is dependent on the particular facts, certain general principles of law may be applied in determining their taxability."

As a partial basis for the conclusions set forth in the ruling, the Commission cited *Matter of Carpenter* v. *Chapman*, 276, App. Div. 634. In that case it was held that professional fees paid to a nonresident attorney admitted to practice in New York were derived from New York sources and hence taxable in New York, notwithstanding the fact that the legal services were performed outside of New York. Since the petitioner could lawfully hold himself out as only entitled to practice law in the State of New York, services performed elsewhere were incidental to the practice maintained in New York. As an analogy the Commission then cited the Surrogate's Court Act to show that both executors and trustees of testamentary trusts are subject to supervision by the Surrogate's Court which has authority to judicially settle their final accounts; also, that their commissions are determined under such Act. Thus, the Surrogate's Court Act is usually applicable notwithstanding the fact that an executor's authority arises from the decedent's will, since he may not exercise such authority until permission is granted by the court of probate jurisdiction; moreover, as to trustees of testamentary trusts, specific sections of the Act apply to such trusts.

Based on the above, answers to questions previously presented are as follows:

1. Commissions paid to a nonresident executor of the estate of a resident decedent, all of whose property was located in New York, are deemed to be derived from New York sources and are, therefore, includible in gross income of a nonresident executor.

2. Commissions paid to a nonresident trustee under a will of a resident decedent, all of whose property was located in New York, are deemed to be derived from New York sources and are, therefore, includible in gross income of a nonresident testamentary trustee.

In each of the above situations commissions so paid will be considered as arising from New York sources even though some or all of the property of the estate or testamentary trust is located outside New York. However, commissions received in connection with ancillary proceedings which are instituted in another state are not includible in the gross income of a non-

resident executor or testamentary trustee. On the other hand, commissions received by a nonresident executor or testamentary trustee in connection with ancillary proceedings instituted in New York involving the estate or a testamentary trust of a nonresident decedent, are includible in gross income of such nonresident executor or testamentary trustee.

3. In the case of an inter-vivos trust, the authority of the trustee is found in the trust instrument and does not arise from permission of the court. As a general rule, commissions paid in connection with an inter-vivos trust are based on the income or corpus of the trust and are not dependent upon the performance of personal services by the trustee. Therefore, the ruling indicates that the source of the income rather than the place where the services are rendered is the important factor in determining the taxability of such commissions. If the corpus of the trust consists of real or tangible personal property located in New York, or the income is derived from such property or from a business conducted in New York, then commissions paid to a nonresident trustee based on such corpus or income are includible in the gross income of the trustee for New York State tax purposes. However, it should be noted that commissions based on intangible personal property, regardless of location or on real or personal property located outside of New York, or on income of such property, are not includible in the gross income of a nonresident trustee.

The above ruling would appear to correspond with the theory expressed in a ruling of the Income Tax Bureau issued January 6, 1934 wherein it was stated that "an individual nonresident who is a co-committee for an incompetent resident, whose property is managed in New York and whose estate pays fees according to the laws of the State of New York, must pay a personal income tax without apportionment."

WITHHOLDING ON PERSONAL SERVICE COMPENSATION OF CERTAIN NONRESIDENTS

On June 28, 1960 the State Tax Commission promulgated Regulations Article 263-a, effective July 1, 1960, the purpose of which appears to insure collection of tax from nonresidents subject to New York personal income tax but not formerly subject to withholding provisions.

Definition of Employee

Under the regulations the term *employee* includes any nonresident who earns compensation for personal services performed in New York State in connection with sporting events or in connection with the preparation or presentation of entertainment, whether as a participant, performer or otherwise. As used in this article, a nonresident earning compensation for personal services in connection with a sporting event, in addition to the actual participants, shall include, but shall not be limited to, referees, trainers and jockey agents. Furthermore, a nonresident earning compensation for personal services in connection with the preparation or presentation of entertainment shall include, but shall not be limited to, actors, singers, musicians, dancers, circus performers, writers, directors, set designers and any person appearing on television or radio, the stage, in a night club performance or hotel show and any person whose performance is recorded or filmed. The term *employee* also includes any nonresident earning personal service compensation in the form of a prize or award paid in cash or securities. Com-

pensation so earned by such nonresident is considered wages subject to the withholding provisions of Section 366 of the Tax Law.

Definition of Employer

The term *employer* under this article means any individual, corporation, association or partnership or any agent thereof, the United States, a state, territory or any political subdivision thereof or any agency or instrumentality thereof or any officer, employee or agent thereof maintaining an office or transacting business within the state who has control, receipt, custody, disposal or payment of compensation taxable under Article 22 and earned by a nonresident in the manner described above.

The regulations further state that in the case of one earning compensation for personal services performed in connection with the conduct of a boxing, sparring or wrestling match or exhibition, either as a boxer, wrestler or otherwise, his employer, for purposes of withholding, shall be the licensee licensed by the New York State Athletic Commission to conduct the boxing, sparring or wrestling match or exhibition in connection with which the boxer, wrestler or other employee under this article is being compensated.

In the case of one earning compensation for personal services in connection with any other type of sporting event or earning compensation for personal services in connection with the preparation or presentation of entertainment, generally, his employer for purposes of withholding shall be the person paying him, or his manager or his agent.

In the case of a winner of an award or prize, generally, his employer for the purpose of withholding shall be the person paying the prize or award to him or his agent.

Procedure in Connection with Withholding of Tax

Each person, whether a resident or nonresident, on or before the date he commences performing personal services of the type described above, shall file with his employer, as defined herein, a Residential and Exemption Certificate, Form IT-2104.2, stating whether or not he is a resident and, if a nonresident, also stating the number of withholding exemptions to which he is entitled. If a person fails to furnish such certificate, he shall be considered as claiming no withholding exemptions and, for purposes of this article, as a nonresident subject to withholding.

Withholding shall be at the rate of 5 percent of the total amount paid after deducting the personal exemptions allowed, except where expenses are allowed. Where expenses are allowed, withholding shall be computed

on the net amount after deducting the personal exemptions and ordinary and necessary expenses allowed, and the rate of withholding shall be the tax rates provided for in Section 602 of the Tax Law. It should be noted that if an employee wishes his employer, in computing the amount subject to withholding, to allow for ordinary and necessary expenses spent or reasonably expected to be spent in earning his personal service compensation, he shall submit to his employer an itemized, signed and dated statement of his ordinary and necessary expenses. The employer may allow the amount claimed where the expenses are bona fide and the amount is reasonable. Where the amount claimed is not in excess of 50 percent of the amount to be paid, the employer may accept such expenses as being bona fide and reasonable in the absence of contrary information. Where the amount of expenses claimed exceeds 50 percent of the amount to be paid, the employer may also allow such expenses if they are bona fide and reasonable. The employer shall preserve the expense statement submitted so that it is available for inspection by the State Tax Commission. Allowance of expenses for purposes of withholding shall have no bearing on the right to a deduction for such expenses on the income tax return filed for the taxable year.

An employee shall be allowed the number of personal exemptions claimed on his Residential and Exemption Certificate except where he receives compensation for personal services from the same employer more than once in the same calendar year. In that case, that employer shall not allow exemptions except where the exemptions claimed for the employee's prior period of employment were greater than the sum received so that no tax was withheld. Where that is so, the employee shall have the right to an allowance for personal exemptions to the extent of his unused exemption or exemptions.

Every employer required to deduct and withhold from an employee a tax under this article or who would have been required to deduct and withhold if the employee had claimed no more than one withholding exemption is required to furnish a statement on Form IT-2102 to each such employee within thirty days after the last payment of compensation for personal services for a period of employment, or by the 15th day of February following the close of the calendar year, whichever is earlier. The statement on Form IT-2102 should show the amount of total wages paid by the employer to the employee during that period of employment, the amount deducted and withheld as tax, and such other information as is required on that form. If the employee is later rehired by the same employer during the calendar year, a separate withholding statement on Form IT-2102 must be furnished to the employee separately covering that period of employment.

An employer shall include the tax withheld under this article on Form IT-2101, the Employer's Quarterly Return of New York State Personal Income Tax Withheld, and file such form in accordance with Article 270 of the Personal Income Tax Regulations. Such employer shall also file the Income Tax Bureau copy (copy no. 4) of each Form IT-2102 given an employee under this article, together with Form IT-2103 (Reconciliation of New York State Personal Income Tax Withheld), in accordance with Article 270 of the Personal Income Tax Regulations.

Administration of A CPA Practice

Conducted by MAX BLOCK, CPA

INTERMEDIATE PERSONAL INCOME TAX WORKSHEET

Practitioners who prepare large numbers of personal income tax returns are forced to develop mass production procedures to efficiently carry out their responsibility within the limited time available. One technique employed by some practitioners to save higher echelon time, is a procedure that sectionalizes the tax return preparation between a preparer and a return writer. A more experienced accountant prepares a worksheet form that is a skeleton of the tax return, including the tax calculation. It is reviewed for accuracy and then passed on to an assistant who transposes the data on to the official tax blank. A brief survey of the return is then necessary to assure that the transcription is complete. This can be made by the return writer himself, in the form of a "second look" or by the person who will sign the return.

One obvious drawback is that an extra form and an additional operation are introduced. Yet this apparent increase in time and effort, according to adherents of this procedure, is well justified on these grounds:

1. The time of the more experienced, higher cost staffmen is reduced substantially.

2. A material saving of time and expense is achieved as the result of a reduction of errors in the preparation of returns.

3. The completion of returns by younger staffmen is good training and preliminary experience.

4. A more efficient scheduling and utilization of staff are made possible.

Worksheets are not prepared for returns that are obviously very simple. Such returns are screened out and assigned for "one-shot" preparation.

STAFF MANUALS

A staff manual for each staff member is an aid to the individual, with some advantages for the firm. The subject has been discussed in this department on several occasions (9/51, 9/52, 7/53, 9/53, and 1/57), but current expressions of interest warrant further reference thereto.

First, let us consider what data may be included in a manual. Some contain only data pertaining to administration policies and practices, such as:

1. Facts as to the firm's policy on personal appearance, conduct, and other personal aspects.

MAX BLOCK, CPA (N. Y., Pa.), is a former chairman of the Committee on Administration of Accountant's Practice of the New York State Society of Certified Public Accountants. He is a lecturer at the Baruch School of Business and Public Administration of The City College of New York in the graduate course on Accounting Practice. Mr. Block is a member of the firm of Anchin, Block & Anchin.

2. Facts as to vacation allowances, overtime, supper money, travel allowances, and scheduled working hours.

3. Facts as to the firm's policy on salary adjustments, bonuses, fringe benefits, promotion bases, and relations with principals.

4. Facts as to staff assignment mechanics, contact with office, organization structure, time reports, expense accounts, payroll periods, and method of payment.

5. Such other information as a firm may desire to publicize.

The manual is helpful to the staff member in several respects:

1. It gives him a feeling of confidence in the firm, engendered by its willingness to publicize its operating policies and practices. No man is content to speculate about a firm's policies on matters that he considers vital. Some are reluctant to inquire for fear that their intention may be misunderstood. A fair, straightforward statement of policy and practices puts a man at ease.

2. The manual is a reference record and it may obviate many questions that otherwise would require a personal interview.

3. Though new staff members may get some indoctrination, it is not likely that they can be told, or retain, all of the information they should have. The manual supplements the oral indoctrination by filling in the gaps of omitted data.

Some staff manuals contain a section devoted to instructions on audit techniques, uniform work paper requirements, financial statement forms, and disclosure requirements; suggestions for good language, illustrative and uniform expressions for opinions, disclaimers, comments, references to scope; and various other data including references to files and personal handling and care of papers.

Such information is valuable to a new staff member because, in a short time, he can learn the firm's policies and standards on auditing and reporting. It is a great aid to the firm since it speeds up the orientation process, thereby making the man more valuable sooner. It is an aid in securing compliance with standards and in maintaining the efficiency that results from uniformity of practices. Such a manual is a valuable reference record and can save time and embarrassment for both the auditor and the firm.

Specimen copies of forms used in auditing and reports may be contained in the manual, to apprise the reader of all forms in use, with instructions as to use in individual instances where helpful. A manual may also include a section on the preparation of tax returns. It may contain instructions as to the gathering of data for tax returns, preparation and review procedures, office forms to be used and specimen copies, use of tax library, tax files, and various other pertinent material.

For large firms, a manual is virtually mandatory. Smaller firms will find one, in less detailed form, a very useful tool for administration and a beneficial factor in good staff relations. In the AICPA's *CPA Handbook,* Chapter 9, there is a discussion of staff (administrative) manuals and a copy of a large firm's manual in Appendices A, B and C. In Charles S. Rockey's book, *Accountant's Office Manual,* there also is a discussion of an employees' manual, with an illustration of one in Exhibit 9.

Payroll Tax Notes

Conducted by SAMUEL S. RESS, CPA

RECENT UNEMPLOYMENT INSURANCE DECISIONS

WIFE'S WAGES NOT TAXABLE

In Appeal Board Case No. 73,762-60, the benefit claimant was a bar maid who had been in the employ of her husband from whom she had been separated but not divorced. When she applied for unemployment insurance her husband protested on the ground that she had not been engaged in covered employment. It was pointed out that Section 511.7 of the Unemployment Insurance Law excludes from coverage, service of a wife in the employ of her husband. The claimant contended that this provision of the law did not apply in her case because she and her husband did not live together and had been separated for more than five years, even though she continued to be employed by him.

The Appeal Board stated that "The term 'employment' does not include service for an employer by his spouse . . ." They construed the designation of spouse to include a husband or wife still legally married. Therefore, her earnings were not subject to tax for unemployment insurance and she could not accrue benefit rights by virtue of such employment.

VACATION PAY AND VACATION FUNDS

The issue in Appeal Board Case No. 72,228-59 was whether or not the period of claimant's unemployment from July 6 through July 19, 1959 is a "vacation period" within the meaning of Section 591.3 of the Unemployment Insurance Law, during which claimant would not be entitled to receive benefits. The Appeal Board reversed the decision of the Referee and granted benefits to the claimant. The latter had received the equivalent of one week's pay from the union vacation fund to which the employer had made weekly contributions based on a percentage of the employee's wages, and a second week's vacation pay directly from the employer. In effect the claimant had received vacation pay for both weeks for which he had claimed unemployment insurance benefits. He had been employed by the employer for the week prior and the week subsequent to the two-week period in question.

The Appeal Board pointed to the following wording of Section 591.3:

A vacation period during which no benefits shall be payable to a claimant is a period:

1. during which a claimant has a temporary respite from work; and
2. for which entire period such claimant

SAMUEL S. RESS, CPA, is engaged in public practice in New York City. Dr. Ress was formerly a member of our Society's Committee on New York State Taxation and chairman of its Subcommittee on Unemployment Insurance.

is given a vacation payment or allowance by his employer *directly* . . ., and

3. where such claimant is substantially fully employed by such employer both during the last work week before and work week immediately following such period . . .

The Appeal Board in construing the word "directly" in the statute, decided that even though the employer had paid the moneys used for the payments by the vacation fund, the requirement of the statute had not been met. The employer had not paid the employee "directly." The "vacation period" disqualification for benefit purposes does not apply when the "vacation pay" is distributed out of a separate "vacation fund" by an administrative committee or by trustees who collect the funds during the course of the year.

The effect of this decision is to make eligible for unemployment insurance benefits, subject to the other requirements of the law, many employees who receive vacation pay from separate vacation funds.

OCCASIONAL AND CASUAL EMPLOYMENT

A benefit claimant had collected $1,170 in unemployment insurance during a period when he was alleged to have been engaged in employment on his mother's farm. Later he returned to his customary work as a truck driver. During the alleged period of his unemployment, claimant assisted his mother who was in debt by advising her and by taking care of correspondence and of her finances. His brother planted the crops and operated the farm. On occasion, claimant spent a few hours helping his brother spray trees. Claimant received no pay for his work.

Despite the Referee's holding that the claimant was not totally unemployed and not entitled to the benefits that he had collected, the Appeal Board in Case No. 73,512-60, reversed the decision below. The Appeal Board stated:

> The record does not support the conclusion of the Referee that claimant was not totally unemployed because he devoted a substantial amount of time to the operation and management of the farm. It is undisputed that during the reporting period involved the farm was owned and operated by claimant's mother and that claimant received no remuneration from her. The credible evidence supports claimant's contention that such assistance as he rendered to his mother and brother was only *occasional and casual and did not constitute employment within the Unemployment Insurance Law.*

It should be noted, however, that in those cases where the benefit claimants allege that they received no remuneration from businesses which they own, operate or control, it is not likely that benefit payments would be allowable for the uncompensated weeks of employment. (See *Matter of Schreiber,* 5 App. Div. 2nd 745; and *Matter of Emery,* 281 App. Div. 426.)

Federal Taxation

Decisions and Rulings—LEONARD H. CARTER, CPA
Guest Editor

Commentary —Committee on Federal Taxation
Chairman, ARTHUR J. DIXON, CPA

DECISIONS AND RULINGS

DEPRECIATION—USEFUL LIFE AND SALVAGE VALUE

The Supreme Court, in its last decision day of the year, promulgated its opinion on various phases of the depreciation deduction allowable under Section 167 of the Code.

In the consolidated case of *Massey Motors Inc.* v. *United States of America, Com.* v. *Robley H. Evans,* Section 23 (e) of the 1939 Code was at issue because the taxable years predated the 1954 Code. Each taxpayer was in the business of renting automobiles and had claimed depreciation on the basis of a four-year useful life. The cars were sold at a profit after a period of use ranging from fifteen to thirty-six months. The Government argued that the claimed depreciation should be reduced on the theory that useful life was not the economic life of the asset (the four years claimed), but only the period it was actually used in the taxpayer's business, and that the basis for computing depreciation should be reduced by salvage value which it claimed to be the resale value of the cars.

The Court adopted the Government's arguments. It was the purpose of Congress to permit a taxpayer to recover, tax free, the total cost of capital assets over the tax years benefited by their use. In most cases, assets are used for their entire economic life, and at the end of such period the salvage value may only be scrap. However, in connection with the type of asset involved in the case before the Court, it is clearly the taxpayer's experience that the asset is used for a substantially shorter period than its economic life, and that there is a substantial salvage or resale value. The Court further stated that it was not the design of Congress to permit a taxpayer to convert a depreciation deduction into a capital gain upon the resale of the asset. Although this case was decided under the 1939 Code, it is equally applicable to the 1954 Code.

In *The Hertz Corporation* v. *United States of America,* the 1954 Code was before the Court. Here too, taxpayer's business was car leasing. It elected to use the double-declining-balance method of depreciation authorized by Section 167 (b) of the Code. However-

ED. NOTE. Richard S. Helstein, CPA, will resume his regular editorship of this department with the November 1960 issue.

ever, Section 167 (c) authorizes this procedure only where the asset has a useful life of three years or more. For the reasons stated in the *Massey Motors, Inc.* decision the Court held that the rapid method of depreciation could not be used because the useful life of the cars used in the taxpayer's business was less than three years.

The other issue in the case related to the depreciation of trucks which concededly had a useful life in excess of three years and were therefore subject to depreciation under the declining-balance method. The Government claimed that the trucks could not be depreciated beyond their salvage or resale value and cited Regulations Section 1.167 (a)-1 (b), issued in 1956 subsequent to the years in issue. Taxpayer contended firstly that the regulation could not be retroactively applied, and secondly that there is a built-in salvage value under the depreciation method used.

The Court rejected the taxpayer's arguments. The regulation is valid and may be retroactively applied. With respect to salvage value, it is true that there is a built-in salvage value but that is not a valid reason for allowing depreciation beyond an amount which the taxpayer will receive when the asset is disposed of. To permit otherwise would distort the expense of employing the asset in the years after that point is reached.

These decisions may create further problems for both taxpayers and the Government. Taxpayers who have been depreciating assets over their economic useful life may now increase their rates to give effect to a shorter period of use in their own business. However, on the other side of the ledger is a possible denial of the additional 20 percent depreciation in the initial year of acquisition where the useful life in the business may be under six years (Section 179).

LEONARD H. CARTER, CPA, is a member of our Society's Committee on Federal Taxation. Mr. Carter is a partner in the firm of Blumberg, Block & Carter, certified public accountants.

BILL EXTENDING CORPORATE TAX RATE

The President signed the bill extending until July 1, 1961 the corporate normal tax rate of 30 percent and all existing excise tax rates. Included in the bill is an amendment to Section 613 dealing with percentage depletion of various minerals and ores. It defines the point for each listed mineral when the percentage depletion must be computed.

Heretofore, some taxpayers claimed the right to compute depletion on the gross income from the finished product, which of course increased the deduction. The Supreme Court, on its last day, denied to the *Cannelton Sewer Pipe Co.* its claim that it could compute depletion on the value of its products such as sewer pipe and flue lining manufactured from fire clay and shale which it mined. The deduction was limited to the depletion percentage based on the value of raw fire clay and shale, after the application of the ordinary treatment processes normally applied by non-integrated miners engaged in the recovery of those minerals. The new bill and the decision give almost identical results.

MORE ON EXPENSE ACCOUNT ALLOWANCES

A Senate amendment to the tax rate extension bill would have imposed severe limitations on the amount claimed for entertaining expenses. This amendment was eliminated in conference, but in lieu thereof there was substituted a provision authorizing the

Joint Committee on Internal Revenue Taxation to make a full study and investigation of the operation of the present law, regulations and practices relating to the deduction of all types of entertainment expenses. It was directed to make its report to the next Congress together with its recommendations for any changes in the law and administration practice which it may deem necessary or appropriate. The Secretary of the Treasury was also directed to report to the next Congress the results of the enforcement program relating to entertainment as outlined in T.I.R. 221 (see NYCPA, June 1960, p. 427) together with his recommendations to prevent misuse of the deductions.

DIVISION OF INCOME AMONG A FAMILY

A recent Tax Court decision approved of the organization of a partnership which had the effect of channeling income among members of a family.

Petitioner was an organizer, officer and director of a Federal Savings and Loan Association. Its principal business was that of accepting deposits and lending money secured by first mortgages on improved realty. The association's activities generated a substantial amount of subordinate and related business, the disposition of which was controlled by the petitioner as chief officer. He consequently was in a position to direct to whomever he pleased, the placement of realty insurance, appraisals, abstracts and allied legal work. This was permissible under the Manual of Rules and Regulations for the Federal Savings and Loan System.

Petitioner had four minor children —19, 16, 14 and 10 years of age. He organized a partnership in which each of his children had a one-quarter interest, each interest being held by his wife as trustee. Each child had a savings account derived from gifts from their parents. The sum of $2,000 was withdrawn from each account for the purpose of an initial capital contribution to the partnership.

The 19-year-old son had been learning the technique of appraising from his father. At the time of the formation of the partnership, he was deemed to be a qualified appraiser and was placed upon the appraisal committee of the association. However, during the years in question he was a full-time college student. It was usually on week-ends that he went out on appraisals. He was also licensed to sell insurance. Petitioner diverted to his son appraisal fees, insurance commissions and other related items which were turned over to the partnership.

The Government contended that the partnership lacked substance and was a sham and that petitioner earned and controlled the income received by the partnership and is therefore taxable on it.

The Tax Court held that control over the disposition of business does not carry with it the responsibility to pay taxes on the income resulting from the business.

> There is a difference between being in a position to control who shall perform the activities which produce the income and being in a position to control either the use of income producing capital or who shall receive income after it is produced, and we think that distinction is basic in this case. This income was not generated until earned by the actual performance of the subsidiary services. The control exercised by petitioner was limited to that of designating who should perform the services.

The Court found that the son performed substantially all the services despite the fact that they were limited to week-ends and after hours. (*Robert B. Crowley,* 34 TC _____ No. 34.)

MISCELLANY

• Code Section 270 provides that an individual sustaining losses in a single trade or business in excess of $50,000 in each of five consecutive years will be allowed deductions only to the extent of $50,000 in each such year. The operation of a professional football team in Boston in 1947 and 1948 and one in New York for 1949-1950 were held to be different trades or businesses which would permit the deduction of losses in excess of $50,000 for each year. (*Joseph M. Collins* v. *Com.*, 34 TC ____ 60.)

• A Circuit Court has heretofore held that payments of a percentage of profits, in lieu of interest, made to a creditor who loaned money to the business, are deductible as interest (*Dorzback* v. *Collision*, CA-3, 3/18/52). In an apparent reversal a court now holds that where a creditor, in return for a lower rate of interest, participated in the appreciation of certain real estate, the payment by the debtor to the creditor of such appreciation is not deductible as interest but is in reality a payment for an equity interest in property. (*Farley Realty Corp.* v. *Com.*, CA-2.)

• A sale of assets followed by liquidation of a corporation pursuant to Code Section 337 cannot convert what is usually ordinary income into excludable income under that section. Accordingly, a bank filing on a cash basis, which sold its assets including accrued interest, was held to have realized ordinary income when the interest was paid by the purchaser. In effect, in lieu of a sale of the right to receive the interest there was an actual collection of the interest. Nonrecognition of gain under Section 337 can only result from a sale or exchange of property. (*Central Building & Loan Assn.* v. *Com.*, 34 TC ____ No. 43.)

• An insurance agent's commissions on a life insurance policy purchased on his own life are compensation for services and therefore are taxable income. (*Com.* v. *Minzer*, CA-5.) This rule has now been extended to a real estate salesman's commission received in the sale of real estate purchased for himself. (*Com.* v. *Daehler*, CA-5.)

• The Treasury Department indicated in Revenue Ruling 55-373 that where there was a sale of a portion of a business by a corporation accompanied by a contraction of corporate activity, a partial liquidation of capital stock to the extent of the selling price received would not be taxable as a dividend. This ruling has now been extended to include in the partial liquidation an amount of working capital attributable to the business activity terminated. (Revenue Ruling 60-232.)

COMMENTARY

BASIS OF PROPERTY RECEIVED BY HEIR OF REMAINDERMAN

What is the basis of trust property received by the heirs of a remainderman where the latter predeceases the life tenant? Under the 1939 Code the courts have concluded that the basis of securities transferred to a residuary legatee or remainderman—whether it be the original remainderman or his beneficiary—is the fair market value as of the date of death of the settlor for property retained by the trustee, and the cost price in the case of property purchased by the trustee. (*Pearson*, 27 TC 330.) The courts evidently overlooked the fact that a portion of the remainder interest, valued at the date of the remainderman's death, is subject to estate tax in the remainder-

man's estate. By requiring the heir to use the "adjusted uniform basis" (i.e., trustee's basis), the heir was thus denied the benefit of any increase in the value of the remainder interest, which increase was included and taxed in the remainderman's estate.

Seemingly without benefit of statutory enactment, the Commissioner's regulations promulgated under the 1954 Code (1.1014-8) have alleviated this hardship by permitting a stepped-up basis (assuming an increase in value of the property) when the trust terminates upon the death of the life tenant who had survived the remainderman. These regulations provide that the basis of any property distributed to the remainderman's heir shall be determined by adding to (or subtracting from) the "adjusted uniform basis" of the property (trustee's basis) the difference between:

1. The fair market value of the remainder interest in the property at the time of the remainderman's death, and

2. The remainderman's "adjusted uniform basis" of the property immediately prior to his death.

For example, assume that a testamentary trust is set up with stock having a value of $1,000 at the time of decedent's death. Income is to be paid to A for life with remainder to B or to B's estate. B predeceases A and bequeaths the remainder interest to C. Assume that the value of the stock at B's death is $1,600 and that A's age at that time is 37. The value of the remainder interest included in B's estate is $547 (.34185, remainder factor at age 37, x $1,600), and B's share of the uniform basis at the time of his death is $342 (.34185 x $1,000). C's basis for the stock distributed to him upon dealth of A, the life tenant, is as follows:

Uniform basis of property upon termination of life interest		$1,000
PLUS: Value of remainder interest in the property at time of B's death	$547	
Minus: B's share of uniform basis of the property at the time of his death	342	205
C's basis for stock distributed upon termination of life interest		$1,205

PERSONAL HOLDING COMPANY TREATMENT OF TAX-EXEMPT INTEREST

Quite frequently, a closely held corporation ceases active conduct of its trade or business and becomes inactive. The stockholders do not intend to liquidate the corporation, in view of the tax cost involved, but contemplate entering a new trade or business at some future date. Its assets are cash or cash items. The stockholders would like to invest these idle funds, at least temporarily, in dividend or interest paying securities. Ordinarily, however, such income would be considered as "personal holding company income" and the corporation might be subject to the personal holding company tax provisions of Section 541 of the Internal Revenue Code of 1954.

COMMITTEE ON FEDERAL TAXATION

ARTHUR J. DIXON, CPA, Chairman, *Oppenheim, Appel, Payson & Co.*
NORMAN E. AUERBACH, CPA, *Lybrand, Ross Bros. & Montgomery*
BERNARD BARNETT, CPA, *Apfel & Englander*
SIDNEY BLUMENBERG, CPA, *own account*
ABRAHAM J. BRILOFF, CPA, *own account*
LEONARD H. CARTER, CPA, *Blumberg, Block & Carter*
ALBERT H. COHEN, CPA, *Price Waterhouse & Co.*
SAMUEL A. DYCKMAN, CPA, *Robert Simons & Co.*
WILLIAM ETKIN, CPA, *Clarence Rainess & Co.*
PAUL FARBER, CPA, *S. D. Leidesdorf & Co.*
HARRY Z. GARIAN, CPA, *Matthew Bender & Co., Inc.*
J. R. GOUGH, CPA, *Arthur Young & Company*
STANLEY B. GREY, CPA, *Marks, Grey & Shron*
HERBERT HABER, CPA, *Gilbert Paneth & Co.*
BERNARD KAYE, CPA, *Seidman & Seidman*
PETER J. LABARBERA, CPA, *MacDevitt & LaBarbera*
PAUL MESTERN, CPA, *Haskins & Sells*
THEODORE METZENDORF, CPA, *Laventhal, Krekstein & Co.*
LEO SPANDORF, CPA, *Kohleriter & Spandorf*
ROBERT A. WIENER, CPA, *own account*

One of the requirements for personal holding company status is that at least 80 percent of the corporation's gross income be personal holding company income (Section 542). Suppose that the corporation invests its idle funds in tax-exempt bonds. Is the interest on such bonds personal holding company income?

In defining personal holding company income, Regulations Section 1.542.2 refers to the sections of the Code defining gross income and the exclusions therefrom. One of these exclusions, contained in Section 103, is interest on the obligation of a state, territory, or possession of the U. S. or any political subdivision of the same. Therefore, it is clear from these provisions of the Code and the Regulations, that tax-exempt interest derived from state or municipal obligations, etc., is not to be included in "gross income" in determining whether the corporation qualifies as a personal holding company under the "80 percent of gross income" test.

Furthermore, the personal holding company tax is imposed on undistributed personal holding company income as defined in Section 545. Undistributed personal holding company income is taxable income of the corporation, subject to certain adjustments. As tax-exempt interest is not included in "gross income," it is also not part of the corporation's taxable income. Accordingly, even if a corporation were to qualify as a personal holding company by reason of its other income, such tax-exempt interest would not be subjected to the tax imposed by Section 541 of the Code.

If, however, the corporation has a substantial accumulation of earnings and profits, the further question may arise as to whether such tax-exempt interest is to be considered in the determination of the accumulated earnings tax provided for in Section 531. Here, also, tax-exempt interest is excluded as this penalty tax is imposed on the "accumulated taxable income" as defined in Section 535. This section is similar to Section 545 in that it uses as its starting point "taxable income." Since tax-exempt interest is not included in computing taxable income, it would also be insulated from taxation under the accumulated earnings tax imposed by Section 531. It should be noted, however, that an investment in tax-exempt bonds may be some evidence of an unreasonable surplus accumulation. Furthermore, the interest, although tax-free, increases surplus to which the test of reasonableness is applied. Therefore, although the tax-exempt interest is not itself subject to the Section 531 tax, its presence may increase the possibility of having the penalty tax applied to other corporate income.

POSSIBLE SOLUTION OF OPERATING LOSS PROBLEM

In an item appearing in this department, July 1960 issue, it was pointed out that a literal interpretation of Section 382(a) could result in the disallowance of a carryover of a loss incurred (as, for example, on the sale of the assets of an unprofitable operation) subsequent to the purchase of the stock but in the same taxable year. This seemingly unfair and probably unintended conclusion results from the two-year rule set forth in the statute for stock acquisitions.

A possible solution has been suggested. The disallowance may be avoided by changing the taxable year of the acquired corporation to terminate shortly after the change in stock ownership and, subsequent thereto, selling the assets of the unprofitable operation so that the loss resulting therefrom will occur in the *second* tax-

able year. In this way, any net operating loss carryover to the third and subsequent years would still be available to the corporation.

INSTALLMENT METHOD
OF ACCOUNTING FOR
REVOLVING CREDIT ACCOUNTS

A number of department stores and clothing chains are planning the adoption of the installment method of reporting taxable income from "revolving credit" accounts, relying on the February 5, 1960 decision in *Consolidated Dry Goods Co.,* 60-1 USTC 9272. "Revolving credit" accounts are known by many names, including "budget accounts," "continuous budget accounts," and "cycle budget account plans." In the *Consolidated* decision, the District Court recognized the taxpayer's "Cycle Budget Account Plan" as a plan qualifying under Code Section 453(a), and described the plan as a typical example of what is known in the merchandising field as a revolving credit plan.

Adoption of the installment method of accounting under Section 453(a) entails possible double taxation in part of amounts collected on installment sales which have previously been included in income in the year of sale. Tax practitioners have believed for some time that such double taxation could be avoided by the sale of installment accounts at the end of the year preceding the year of adoption of the installment method for federal tax purposes. In Revenue Ruling 59-343 the Internal Revenue Service announced that it would follow the decision in *City Stores Co.* v. *Smith,* 154 F. Supp. 348, in which the double tax was avoided where there had been a *bona fide* sale of installment obligations. Practitioners have felt, however, that sufficient problems in this area still exist to warrant the application for an advance ruling before the sale transaction is consummated. As a result of such requests, a number of favorable advance rulings have been received.

There are several important contract features involved in the sale of installment accounts which must be correctly treated in the agreement of sale to assure Service recognition of the transaction as a bona fide sale and thus to avoid double taxation of the amounts collected thereafter from customers. A few of the more important features are the evidence of ownership by the purchaser, the portion of the selling price withheld as a reserve for losses, and the treatment of defaulted accounts.

There still exists a question of whether revolving credit accounts qualify under Code Section 453(a). The regulations under Section 453 do not contain any rules dealing with this question. Instead, when the final regulations under Section 453 were issued in September 1958, the introductory paragraph included the following statement: "Consideration is being given to the issuance of separate rules dealing with the matter of whether income from so-called 'revolving credit sales' may be reported under the installment method of accounting provided for under Section 453."

Little has been done by the Service on the revolving credit issue lately, principally because of the *Consolidated* decision. From informal soundings the Service appears to lean toward recognizing the revolving credit type of plan as an installment plan for purposes of Section 453(a). However, the ultimate Service position on this issue will depend to a great extent on the outcome of the expected *Consolidated* appeal, and the Tax Court's opinion in the *Emporium* case now docketed with that Court. Meanwhile, the Service will not issue official rulings on this question until its position has been determined.

Classified Section

RATES: "Help Wanted" 20¢ a word, minimum $5.00. "Situations Wanted" 10¢ a word, minimum $2.00. "Business Opportunities" 15¢ a word, minimum $3.00. Box number, when used, is two words. Closing date, 10th of month preceding date of issue.

ADDRESS FOR REPLIES: Box number, The New York Certified Public Accountant, 355 Lexington Avenue, New York 17, N. Y.

HELP WANTED

Home Office of National Organization is seeking an aggressive, experienced accountant, heavy accounting background, both public and private, supervisory experience necessary, CPA, excellent starting salary, extensive benefit program. Reply with resume stating education, experience and salary desired. Box 2097.

CPA, to manage small CPA branch office in Virginia, excellent opportunity for business builder, starting salary $5,000 to $6,000, future partnership status possible. Box 2115.

CPA, AICPA, NYSSCPA, 7 years experience, seeks four days weekly one or more CPAs per diem. Box 2125.

SITUATIONS WANTED

CPA, lecturer in taxation, extensive tax experience in planning and research, former revenue agent and technical adviser, seeks per diem arrangement. Box 2098.

Financial Reports, tax returns, etc., typed and checked expertly by qualified and highly experienced typist, electric, good service. Corona, MU 7-3890, FI 7-1312.

Secretary-Typist, electric typewriter, varied accounting, secretary experience, available after 4:30 p.m. and weekends, no homework, earnest, mature, accurate. Box 2120.

Accountants' Reports expertly typed, IBM, accuracy and quality guaranteed, low overhead equals low rates. Miss Claire, MU 2-0326, evenings and weekends LE 4-8336.

CPA, part-time, experienced punched tape and tabulating services. OX 5-6893, Box 2099.

CPA, 25 years public experience in all phases of accounting with emphasis on institutions, non-profits fund-raising, hospitals, investments, funds, real estate, etc., seeking part-time or per diem work. Box 2100.

CPA, tax experienced, seeks per diem arrangement with accountants involving tax preparation or checking, research, etc. Box 2101.

CPA, 37, 8½ years treasurer-secretary, controller medium size central New York corporation manufacturing and wholesaling consumer product nationally, previous 3½ years in public accounting, desires association with practitioner planning retirement within 5 years, ultimate goal is ownership of practice through outright purchase or equitable income arrangement, will relocate. Box 2113.

Executive Secretary, varied accounting experience, earnest, mature, expensive. Box 2121.

CPA, specializing in SEC work, registration statements, etc., wishes per diem or fee work with other accountants. Box 2116.

Assistant Controller, office manager, CPA, shirt sleeve executive, mature, reliable, many years experience, seeks responsible position, private industry, salary open. Box 2129.

BUSINESS OPPORTUNITIES

Mail and Telephone Service, desk provided for interviewing, $7.00 per month, directory listing. Modern Business Service, 505 Fifth Avenue (42nd Street).

Practice Wanted, substantial terms, know-how offered overburdened or retiring practitioner, CPA, N. Y., N. J., AICPA, IE, MBA. Box 2102.

Well Equipped CPA Firm, will purchase all or part of the practice of overburdened or retiring accountants, substantial cash or attractive retirement arrangements will be offered. Box 2103.

We Act As Your Secretary, mail, telephone service, $5.00 per month, mail and messages forwarded, private desks and offices available, convenient to all transportation. Abbott Service, 147 W. 42nd St., Cor. Broadway.

BUSINESS OPPORTUNITIES

Reliable and Dependable, mail, telephone service with a distinctively personal touch. New York Mail Service, 210 Fifth Avenue, MUrray Hill 3-9221.

For Rent, air-conditioned attorney's suite, private rooms, recently completed, beautiful decor, facilities, extra space available during tax season, individual or small firm, moderate. WOrth 2-1655.

Practice or individual accounts wanted for purchase by CPA with 20 years experience, no account considered too small. Box 2104.

CPA, Society member, 12 years diversified experience, own practice, seeks association with overburdened practitioner or firm, interested in partnership or purchase of clients. Box 2105.

CPA, Society member, competent, experienced, with own modest practice, will purchase or service small number of accounts. Box 2106.

CPA, thirteen years experience, seeks association with overburdened or retirement conscious practitioner, desires purchase or manage practice or individual accounts. Box 2107.

Small Offices, Desk Spaces, suited to your needs, cheerful, air-conditioned. Telephone and secretarial services available. Suite 668, 11 Broadway, WH 4-0157.

CPA, has space in midtown suite, air-conditioned, beautiful decor, object sharing staff facilities and other mutual benefits leading to possible merger. Box 2108.

CPA, over twenty years of diversified public accounting experience, has $8,000 gross and free time, seeks association with overburdened practitioner. Box 2109.

CPA, attorney, 30, LLM (taxation), Society award winner, tax editor, thoroughly experienced, will purchase accounting practice or individual accounts. Box 2127.

CPAs desire to purchase practice or individual accounts. Cash available. Box 2128.

42 St. 11 W., light office to share, carpeted, furnished, Prentice Hall Service available, single practitioner, telephone answered, reasonable. Box 2111.

Private Office and work space for CPAs (4), furnished or unfurnished, midtown, share typing, Bruning, tax services. Box 2112.

Accountants Service Center offers a place to keep things, obtain phone answering service, receive mail, meet a client, do tax research, get reports typed and other chores handled in exchange for an economical sum. Cost can be as low as $5 a month. A whole floor of office and desk spaces at 120 Liberty Street, BArclay 7-5816.

CPA, seeks partnership with overburdened practitioner who is contemplating retirement. Box 2114.

501 Fifth Avenue, 2 air-conditioned offices in newly decorated CPA suite, also rooms for your secretary and staff. Lease available to April 30, 1965. Murray Hill 2-1887.

CPA, desires to purchase practice or individual accounts in Nassau or Suffolk Counties. Will consider partnership arrangement, funds available. Box 2117.

CPA, modest practice seeks associate under 45 with self-supporting practice to explore partnership possibility and 10 years later continuing on retirement. He must be forward looking with vision to cast off old delusions, suspicions and reluctances to merge for present mutual benefits and enjoyment of future security. Submit brief resume in strict confidence. Box 2118.

Expanding New York City Certified Firm, desires to purchase practice in New York City area, including Long Island, attractive arrangements and substantial consideration. Box 2119.

Desk Space Available, new law suite, midtown area, air-conditioned, library. OXford 7-6068.

CPA, Westchester, seeks responsible small practitioner to share office with later partnership in view. Box 2122.

CPA, former revenue agent, extensive tax experience. Gross accounting billings, exclusive of tax work, $35,000. Will merge for growth. Box 2123.

CPA, attorney, 38, own practice, seeks opportunity to put ability and experience to maximum use by association or partnership with single practitioner or firm. Cash available if required. Box 2124.

is ap-
ntancy
terest.
oday's
rough
ect is
s busi-
or the
rket.

of re-
pies of
nted it
sed to
or obli-
ounting

write
Growth
ned for
It de-
nguage
orm of
es five
d and

ion

PRINTED IN U.S.A.